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March 27, 2006

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0310  
Email: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Reference: File Number 265-23

Dear Mr. Katz:

I appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC) request to assess the current regulatory system for smaller companies under the securities laws, including the impact of the Sarbanes-Oxley Act of 2002. As discussed *infra*, a multivariate approach is suggested that combines scale (less than 100 \$MM) and negative cash flow as the best-fit descriptors of a small public company. I also recommend that the current small company exemptions be continued until tests for an efficient-governance universe can be conducted and their results considered.

Comments on the committee's proposals have been varied and diverse with attitudes and opinions more indicative of personal perspective than settled financial thinking. The "Information Age" challenge for policy makers is to adapt existing regulatory context to the commercial patterns of differing governance universes. This paradigm shift changes governance emphasis from "no," proscriptive operational commands on smaller companies to "know," prescriptive proportionate regulation that balances commands and incentives for smaller companies. "Know" governance shifts the focus of public oversight from investor *financial capacity* to investor *financial capability*. It enables investors in publicly traded smaller companies to better adapt to economic changes as developments occur. To this end, this comment puts forth standard tests based upon settled financial thinking to enable a consensus from which governance of smaller public companies can move forward in a global "Information Age".

Small-cap issuers differ from the well-capitalized Russell 3000 in more ways than scale. I argue that small-cap stocks react differently to what is deemed material information for large-cap stocks. For example, tax cuts for companies with negative cash flow and negative income are less "bullish" than for those large-cap, profitable companies with positive cash flow. For smaller companies' regulation to be effective and efficient, it should mirror the realities (pricing and practices) of the market place for issuers, investors, and intermediaries. This suggests that there be:

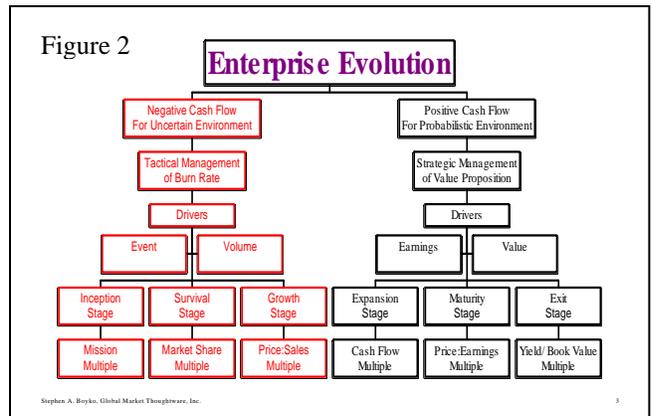
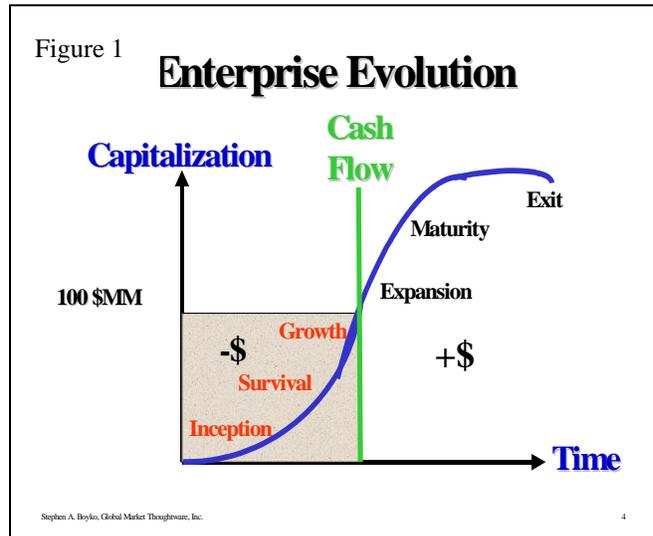
1. A precise, multivariate definition for "smaller" public companies, and
2. An "efficient governance universe" for smaller companies that exist in an uncertain economic environment.

**Definition for “smaller” public companies**

One subject of committee discussion was the definition of “small” for the issuer’s size. To this end, the committee included companies whose capitalization was \$787 million as representative of a small issuer.

Unfortunately, one-dimensional definitions lack relationship clarity to deal with the complexities of today’s financial markets. The SEC definition of “accredited investor” illustrates the sole criterion definition fallacy. The SEC states that its considerable regulatory experience enables it to define the term “accredited investor” to strike the appropriate balance between the necessity for investor protection and meaningful relief for small business offerings. Yet the “accredited investor” test is primarily a measure of self-insurance<sup>1</sup> that neither addresses an investor’s financial sophistication nor differentiates small-cap versus large-cap categories of investment analysis. This raises the question whether a financial neophyte can become a sophisticated investor simply by winning the lottery?

To correct this deficiency and enhance definitional clarity, a multivariate approach is suggested that combines scale (less than 100 \$MM) and negative cash flow as the descriptors of a small public company. The gray box in Figure 1 represents this area.<sup>2</sup> Cash flow is the managerial bright line for smaller public companies. Companies with a negative cash flow emphasize tactical management of their “burn rate” to survive, while companies with positive cash flow emphasize strategic management of the enterprise’s value proposition to create value. Unlike positive cash flow companies that employ risk management techniques to maximize value in a probabilistic environment, negative cash flow companies seek to minimize dilution from their burn rate by selling stock and product in an uncertain environment until their critical event occurs (e.g., FDA patent approval). As illustrated in Figure 2, enterprise evolution consists of



<sup>1</sup> Regulation is essentially operational insurance that uses commands instead capital to produce a result.

<sup>2</sup> Combining scale and negative cash flow criteria closes potential loopholes to large-cap GM-and-Lucent types to provide a tighter definition.

negative and positive cash flow periods with each period comprising of three separate stages. The crossover from negative to positive cash flow occurs as the growth stage, where the company is valued on price-to-sales ("PSR") ratio, evolves into the expansion stage that values the company as a multiple of cash flow. To more precisely define smaller companies that exist in an uncertain economic environment, it is suggested that the criteria of scale and cash flow be combined.

To support this suggestion, a preliminary review of the COMPUSTAT database indicated that 1,190 issuers with negative cash flow had a capitalization of less than \$100,000,000 in the year 2004. This represented approximately seventy percent of public companies with negative operational cash flow.<sup>3</sup> This provides the committee with a tighter definition. To this point, the committee's discussions have equated scale (capitalization) with risk.<sup>4</sup> This is false construct since smaller companies exist in an indeterminate or uncertain economic environment until they achieve their critical event and attain positive cash flow. The better question is whether business failure in an indeterminate environment is a test for Scienter? Further, the committee has suggested that smaller companies capitalized under \$125,000,000 be provided relief from the provisions of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404) that requires each annual report of a public company to include a report by management on the company's internal control over financial reporting. To create an efficient governance universe, why not explore the possibility of extending this logic to other areas of securities regulation?

### **Efficient Governance Universe (EGU)**

For the SEC to develop an efficient-governance universe,<sup>5</sup> the equity capital market needs to be segmented into two components. One for probabilistic, earnings-driven, large-cap issues having positive cash flow that is currently well-regulated by the existing regulatory regime, and one for uncertain, event-driven, small-cap issues having negative cash flow.

Accordingly, it is suggested that a knowledge-based approach that emphasizes financial capabilities (versus financial capacity) should be created. This approach would be specifically tailored for smaller companies to advocate not less, but appropriate and proportionate regulation. This regulatory approach would require advisors and investors to demonstrate that they have sufficient sophistication to allow them to analyze and value young entrepreneurial firms. Entrepreneurial firms are characterized by constant transformation. A regulatory model focused on advisor and investor capabilities can adapt to change as these developments occur.<sup>6</sup>

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<sup>3</sup>Does not consider the effect of the SOX \$1,500,000 annual expense upon cash flow.

<sup>4</sup> If this is so, statistics should be provided to support this contention.

<sup>5</sup> An efficient governance universe is one where material information evidences a high degree of correlation with commands and incentives

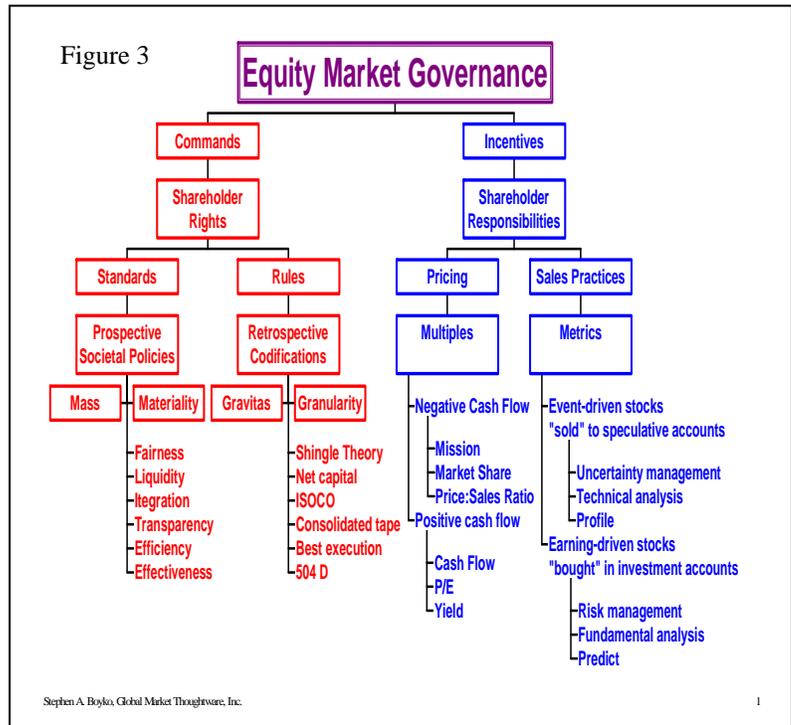
<sup>6</sup> These concepts were contained in an article entitled "Small is Beautiful", The National Interest, No. 77 – fall 2004. The article was presented in the fall 2004 SEC Small Business Conference and subsequently has been well received by global emerging markets—reference: [http://www.findarticles.com/p/articles/mi\\_m2751/is\\_77/ai\\_n6353167/print](http://www.findarticles.com/p/articles/mi_m2751/is_77/ai_n6353167/print).

Regulators create governance regimes by choosing appropriate commands for the incentive set available in the economy. This balances command costs attendant to shareholder rights with incentive benefits derived from shareholder responsibilities. Given the regulatory emphasis to protect shareholder rights, has similar effort been given to monitor shareholder responsibilities? Otherwise, promulgating rights in the absence of responsibilities reduces to unlegislated subsidies. I argue that the likelihood of such unlegislated subsidies is greatly reduced in a knowledge-based EGU.

Shareholder rights are a composite of rules and standards (Figure 3). Standards are prospective societal policies that define industry effectiveness. They are defined in terms of “mass” indicating the number of people affected by the command and “materiality” indicating the relative importance of the command. Rules, on the other hand, are the retrospective codification of best-practice procedures that define operational efficiency. They are industry proscriptions that explicitly delineate organizational limits in terms of *gravitas* and granularity. *Gravitas* is

the seriousness of a violation as measured by the amount of a fine or punishment. Granularity is the degree of precision required to ensure compliance.

Incentives are the expectation of reward to induce action or motivate effort in seeking a net benefit measured in terms of economic profit. As illustrated in Figure 3, the pricing and sales practice incentives are different for issuers having negative versus positive cash flow. Firms with negative cash flow are priced as a function of their mission, market share, or price-to-sales ratio depending on their stage of development. These event-driven stocks are “sold” to speculative accounts by profiling a model for success with technical analysis to help reduce uncertainty. Firms with positive cash flow are priced as a function of their cash-flow multiple, price-earnings multiple or yield / book value multiple depending on their stage of development. These earnings-driven stocks are “bought” by investment accounts by predicting operational results with fundamental analysis based on risk management techniques such as SOX 404. Given a different set of incentives, a separate command structure for each category appears to be a precondition for an efficient governance universe.



Market segmentation is a natural byproduct of economic maturation. As markets become more robust, consumers seek financial instruments tailored with increasing precision to their needs. For example, when the demand for housing increased in the latter half of the 20th century, the thirty-year, fixed-rate mortgage was tailored to accommodate different maturities, variable interest rates, negative amortization, and balloon payments. As standardized mortgage niches attained critical mass, they were securitized to mobilize capital efficiently and drive down the cost of capital.

Unlike segmented bank and insurance regulations, questions arise as to whether the SEC's one-size-fits-all regulatory approach has reached the point where it creates dislocations that frustrate the processing of information for smaller companies and conflict with established financial theory?<sup>7</sup> To illustrate, Nobel Prize Winner, Harry Markowitz, originated basic portfolio theory in the early 1950's. Markowitz was among the first to attempt to quantify risk and demonstrate how stock prices react to financial information. A correlation coefficient is a measure of the degree to which an issuer's stock price reacts to material market information. The value of the correlation coefficient ranges from -1 to +1. For a value of +1, issuers are perfectly positively correlated and their stock prices move simultaneously in the same direction and magnitude. Assets, which have a correlation coefficient of -1, are perfectly negatively correlated and their stock prices move simultaneously in opposite directions and magnitude. A correlation coefficient of 0 indicates there is no relationship. If material information relative to smaller issuers does not correlate with large-cap metrics (and vice versa), each category should be governed under separate regulatory regimes.

Since availability of resources and time constraints do not permit an analysis at this time, I suggest that an extension of time be granted until a test can be conducted that would, among other things:

- Identify the date of public disclosure of material information.
- Estimate the cumulative abnormal returns surrounding the date of disclosure.
- Perform multivariate regressions in which the estimated cumulative abnormal returns is the dependent variable, cash flow is the key explanatory variable, and other variables included as controlling variables.

These regressions will include a fixed effects model to control for cross-temporal and cross-industry effects.

## **Conclusion**

The SEC contends that by granting administrative relief, it provides proportionate regulation for investor protection and for robust capital formation for small-cap issuers. Yet when exceptions to the rule become the rule, systemic change is needed. Making incremental content changes upon a flawed structural process is a *non sequitur*. Fundamental questions must be asked to ensure proper sequence and timing

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<sup>7</sup> The insurance industry differentiates its practices between a "foreseeable" act that is probabilistic in terms of risk management and an "unforeseeable" act that is indeterminate in terms of uncertainty.

of market reforms. For example:

- Does the goal of protecting undifferentiated investors impose commercial censorship on smaller issuers?
- How can there be transparency if information does not correlate to form an efficient governance universe? And,
- Given different pricing and practice metrics for large-cap and small-cap companies, can the SEC govern fairly with one-size-fits-all regulation?

Preferences without financial constructs produce “Goldilocks Governance” where continuous iterative processes (i.e., administrative relief) determine whether \$100 million, \$125 million, or \$150 million is the sufficient amount of regulatory porridge.

Markets monetize informational value as they allocate resources to their highest and best use. For this to happen effectively and efficiently, I argue the SEC must evolve its regulatory scope beyond “risk” management for large-cap issuers, to include the condition of “uncertainty” that defines the economic environment in which smaller public companies exist. Imposing probabilistic commands to attain predictive capability for equity markets characterized by “uncertainty” provides little benefit while raising the cost of opacity as commerce moves to economic externalities.<sup>8</sup>

Rather than roll back regulation as unlegislated subsidies, let us move forward with multivariate definitions to form efficient governance universes as the preferred analytical metrics for global markets in the “Information Age”. This action would be consistent with the SEC’s segmented-approach for intermediaries requiring brokers to be qualified with specific product knowledge (e.g., Series 4 option test) and broker/dealers to have sufficient net capital to function as clearing versus non-clearing firms (SEC Rule 15c3-1). Employ strategies that have worked for intermediaries to issuers and investors to ensure balance between shareholder rights and shareholder responsibilities.<sup>9</sup>

I trust these comments have been responsive to your request. Should you have any questions, I would welcome the opportunity to discuss them with you.

Respectfully submitted,

Stephen A. Boyko, President  
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<sup>8</sup> Reference the GAAMA Model, Comments on Release No. 34-49695, and File No. S7-22-04 (June 9, 2004), <http://sec.gov/rules/policy/s72204/saboyko060904.pdf>

<sup>9</sup> The London Stock Exchange’s AIM rules that appoint and retain nominated advisers for both listing and trading illustrates a knowledge-based efficient governance universe that works for small-cap companies.