U. S. Securities and Exchange Commission

Final Report
of the 21st Annual SEC

Government-Business Forum on Small Business Capital Formation

February 2003

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The staff of the Office of Small Business Policy in the Division of Corporation Finance of the U.S. Securities and Exchange Commission compiled this report from recommendations made at the Forum. The recommendations in this report, however, are those of the private Forum participants and not necessarily the views of the Securities and Exchange Commission, its Commissioners or any of the Commission's staff members.

Preface

On September 26 and 27, 2002, the 21st Annual SEC Government-Business Forum on Small Business Capital Formation met in Arlington, Virginia. The recommendations from the 21st Annual Forum follow. We believe that these recommendations contain many worthwhile proposals. The Forum participants gave careful consideration to a wide range of issues.

One purpose of the Forum is to give the capital-raising needs of small business greater attention, with the hope that these needs may be accommodated, consistent with investor protection.

We thank all who made presentations at the Forum and all other Forum participants for their efforts, and are pleased to present this report.

Executive Committee for the
21st Annual SEC Government-Business Forum on
Small Business Capital Formation

Chair: Mauri L. Osheroff, Associate Director (Regulatory Policy)
Division of Corporation Finance
U. S. Securities & Exchange Commission
Washington, D.C.

Members: Jerry Arnold, Professor of Accounting
Leventhal School of Accounting
University of Southern California
Los Angeles, California

Charles Bennett, Vice President of Compliance
Horner, Townsend and Kent
Horsham, Pennsylvania

Albert S. Dandridge, III
Schnader, Harrison, Segal & Lewis, LLP
Philadelphia, Pennsylvania

Jerry Feigen, Adjunct Professor
Georgetown University Law Center; and
President, Jerry Feigen Associates
Potomac, Maryland

Bruce Goldberg
National Emerging Business Services
Pricewaterhouse Coopers
Philadelphia, Pennsylvania

John J. Huntz, Managing Director
Fuqua Ventures, LLC
Atlanta, Georgia

Daryl Jackson
Deloitte Touche, LLP
Houston, Texas

Nellie Liang
Assistant Director and Chief of the Capital Markets Section
Division of Research and Statistics
Federal Reserve Board
Washington, D.C.

Marc Morgenstern
Kahn Kleinman
Cleveland, Ohio
(Representative from the American Bar Association Section on Business Law, Committee on Small Business)

Russell Orban
Assistant Chief Counsel
Office of Advocacy
U.S. Small Business Administration
Washington, D.C.

Thomas Selman, Vice President
NASD Regulation, Inc.
Rockville, Maryland

S. Anthony Taggart, Director
Division of Securities
Department of Commerce
State of Utah
Salt Lake City, Utah; and
Chair of the Corporate Finance Section Committee
North American Securities Administrators Association, Inc.

Barry Wides, Director
Community Development Division
Office of the Comptroller of the Currency
Washington, D.C.

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2002 Forum SEC Staff

Mauri L. Osheroff, Associate Director
Division of Corporation Finance

Office of Small Business Policy
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Anthony G. Barone
Marva D. Simpson
Corey A. Jennings
Kevin M. O'Neill
Twanna M. Young

Agenda

First Day – September 26, 2002

Introductory Remarks The Honorable Roel C. Campos
Commissioner
U.S. Securities and Exchange Commission

Presentations

Finders/Small Broker-Dealers Panel:

Marc Morgenstern
Kahn Kleinman
Cleveland, Ohio

Tim Cox
Assistant Attorney General & Chief, Securities Registration
Office of the Attorney General
Baltimore, Maryland

Richard (Chip) Morse
Morse, Barnes-Brown & Pendleton, P.C.
Waltham, MA

Paul Mathews
Manager
Underwriting Policy & Investigations
Corporate Financing Department
NASD

SEC Division of Market Regulation Panel:

Nancy J. Sanow, Assistant Director
Joan M. Collopy, Special Counsel
Joshua S. Kans, Special Counsel

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* On both days of the Forum, participants most interested in tax policy matters met in several separate sessions headed by Russell Orban, Assistant Chief Counsel, Office of Advocacy, U.S. Small Business Administration. Their program also included meetings with Congressional staff members specializing in taxation issues. Participants most interested in securities law matters were divided into three separate break-out groups which also met throughout both days of the Forum following the panel presentations. These tax and securities sessions produced and endorsed the recommendations contained in the following section of this report.

Luncheon Speaker Dean Shahinian
Counsel
Committee on Banking, Housing and Urban Affairs
U.S. Senate

Presentations

"Venture Capital Index" Presentation:

Susan E. Woodward
Chairman and founder
Sand Hill Econometrics
Menlo Park, California

Executive Compensation Panel:

Marc Morgenstern
Kahn Kleinman
Cleveland, OH

William Dunn
PriceWaterhouseCoopers LLP
Philadelphia, PA

Paula Dubberly
Chief Counsel
Office of Chief Counsel
SEC Division of Corporation Finance

SEC Division of Corporation Finance Panel:

Alan L. Beller, Director
Martin P. Dunn, Deputy Director
Mauri L. Osheroff, Associate Director (Regulatory Policy)
Elizabeth M. Murphy, Chief, Office of Rulemaking

Second Day – September 27, 2002

Introductory Remarks

Thomas Sullivan
Chief Counsel for Advocacy
Office of Advocacy
U.S. Small Business Administration

Gregory Dean
Banking Counsel
Committee on Small Business and Entrepreneurship
U.S. Senate

Presentation

SEC Division of Investment Management Panel:

David B. Smith, Jr. Associate Director
Nadya B. Roytblat, Assistant Director
James M. Curtis, Special Counsel
Eric S. Purple, Senior Counsel

Luncheon Speaker

Jonathan Silver
Managing Partner
Core Capital Partners
Washington, D.C.

Introduction

As mandated by the Small Business Investment Incentive Act of 1980, the U.S. Securities and Exchange Commission hosts an annual forum that focuses on the capital formation concerns of small business. Called the "SEC Government-Business Forum on Small Business Capital Formation," this gathering has assembled for 21 years. A major purpose of the Forum is to provide a platform for small business to highlight perceived unnecessary impediments to the capital-raising process. Previous Forums have developed numerous recommendations seeking legislative and regulatory changes in the areas of taxation, securities and financial services regulation and state and federal assistance. Participants in the Forum typically have included small business owners, venture capitalists, government officials, trade association representatives, academics and small business advocates. In recent years, the format of the Forum typically has emphasized small interactive break-out groups developing recommendations for governmental action. Like last year, this year's Forum was held at the Key Bridge Marriott Hotel in Arlington, Virginia. The dates of this year's Forum were September 26 and 27, 2002.

The Forum is governed by an Executive Committee comprised of senior government officials and representatives of small business who have a strong interest and expertise with the issues and capital-raising problems of small business. The Executive Committee organizes and plans the Forum.

The Executive Committee had determined that the focus of this year's Forum would be the same as last year's, the areas of taxation and securities regulation. The format of the Forum included panel discussions, luncheon presentations, consultations with Congressional staff and interactive break-out groups.

On the first day of the Forum, the Honorable Roel C. Campos, Commissioner, U.S. Securities and Exchange Commission, offered welcoming remarks. Private sector representatives then led a panel discussion on the topic of finders and small broker-dealer registration issues under the Securities Exchange Act of 1934. This panel was followed by a panel of staff members from the SEC's Division of Market Regulation on the same topic, as well as on other issues of concern to the Division of Market Regulation. The Market Regulation panel was followed by a question and answer session. Dean Shahinian, Counsel to the U.S. Senate Committee on Banking, Housing and Urban Affairs, gave a luncheon address on the legislative history of the recently adopted Sarbanes-Oxley Act of 2002. His address was followed by a presentation by former SEC Chief Economist Susan Woodward, the founder and chairman of Sand Hill Econometrics. Ms. Woodward briefed the assembled group on her firm's "venture capital index," referred to as the "Sand Hill Index," which provides a tool for measuring venture capital risk and return. Two afternoon discussion panels followed lunch on the first day. The first panel covered executive compensation issues and included speakers from both the private sector and the SEC's Division of Corporation Finance. The second panel was led by Alan Beller, Director of the SEC's Division of Corporation Finance, and included

other senior staff members of the Division. Break-out sessions for the Forum participants were held throughout both days of the Forum.

On the second day, Thomas Sullivan, Chief Counsel for Advocacy, Office of Advocacy of the U.S. Small Business Administration, offered welcoming remarks. He was followed by Gregory Dean, Banking Counsel to the U.S. Senate Committee on Small Business and Entrepreneurship, who also provided welcoming remarks. Staff members from the SEC's Division of Investment Management then held a panel discussion on issues within the expertise of their Division. The luncheon address was offered by Jonathan Silver, Managing Partner of Core Capital Partners, who addressed the current economic picture for venture capital. Following lunch, the Forum participants gathered to consider the recommendations developed in the two days of break-out discussions.

On both days, participants most interested in tax policy matters met in several separate sessions. Their program also included meetings with Congressional staff members specializing in taxation issues.

The break-out sessions produced and endorsed the recommendations contained in the following section of this report.

While the SEC hosts this annual convocation of small business friends and advocates, and is pleased to do so, the SEC in no way seeks to endorse or edit any of the Forum's recommendations. While a number of these matters are of substantial interest to the SEC as an institution, it takes no position on any of the recommendations. The recommendations are solely the responsibility of the Forum participants from the private sector.

SEC Government-Business Forum on Small Business Capital Formation Recommendations

TAXATION RECOMMENDATIONS

INCREASE THE AVAILABILITY OF SECTION 1202 QUALIFIED SMALL BUSINESS STOCK

The 1993 tax law changes in Sections 1202 and 1045 of the Internal Revenue Code, which were designed to attract capital to small businesses, were a small first step in "leveling the access to capital playing field." They are meaningless, however, without critical changes. Under current law, the benefit of Section 1202 is negated by the operation of the Alternative Minimum Tax (AMT). Gains from "patient" investments of five years in qualifying small businesses are taxed at an effective rate of 19% when the AMT is applied, while gains from investment of one year in blue-chip big businesses are taxed at 20%.

Recommended changes in order of importance are:

- Section 1202 gain should be exempted from AMT. Under the current AMT structure, almost all of the tax incentives created by IRC Section 1202 are taken away by the AMT;

- the tax rate on capital gains for Qualified Small Business Stock should be set at 50% of the rate on long-term gains. (For example, the current long-term capital gains rate is 20%; therefore, qualifying Section 1202 stock would be taxed at an effective rate of 10%.);

- Sections 1202 and 1045 should be available for investors in "Subchapter S Corporations" and other forms of legal entities, such as limited liability corporations and limited liability partnerships, where the subject entities meet all other requirements of Section 1202;

- expenditures that qualify under the working capital rules listed in Section 1202 should be based on sound business judgment and not an arbitrary two-year limit;

- Section 1045 should be amended so that investors in qualifying small businesses would have 180 days to "roll over" investments into other qualifying businesses rather than the current 60 days; and

- the maximum capitalization level should be raised for qualification under Section 1202 from $50 million to $100 million.

BRIDGE ACT - PROPOSED FINANCING FOR FAST GROWTH SMALL COMPANIES

The Forum recommends that Congress carefully review and adopt the so called "Bridge Act" (H.R. 3062, 107th Congress). This proposal provides a new source for financing during the crucial high-growth period of new companies by allowing qualifying companies to retain a portion of their tax obligation (up to $250,000) to be paid back with interest over four years. The companies are selected based on a two-year history of 10% growth or more. Through an investment in the future of small businesses, this tax incentive program is also expected to pay for itself by generating a modest amount of program income over ten years.

STANDARD DEDUCTION FOR BUSINESS RETURN FILERS

It has long been possible for individuals to elect a fixed amount "standard deduction" regardless of the size and complexity of their tax returns. This simplification policy recognizes that practically all taxpayers have deductions they could itemize but some prefer to use a single, modest deduction amount instead to avoid the complexity, burden, and exposure of itemizing each deduction.

The IRS and others have studied the possibility of creating a business standard deduction. The studies already have determined that the implementation of such a provision, if properly constructed, would not unduly reduce revenue, and would substantially reduce the burden to the government and the taxpayer of both record keeping and paperwork retention. Also, the policy would encourage very small new businesses to come forward and enter the tax rolls because of the non-threatening, simplified process. The Forum believes that the IRS has the authority to create a business standard deduction but that legislation would facilitate its implementation.

We urge the IRS and the Congress to work together to implement a standard deduction of a fixed dollar amount for all business filers to be deductible in a set amount or a variable amount based on the income from the business, whichever is lower.

SELF-EMPLOYED HEALTH CARE DEDUCTION TAKEN FROM ENTITY INCOME

In 2003 self-employed individuals will finally achieve 100% deductibility of health insurance costs for federal tax purposes. As a matter of taxpayer equity, the cost of health insurance for all participants should be deductible from the entity, (*i.e.*, corporations (C & S), partnerships, and sole proprietorships) so as to derive net income. This will provide equitable treatment among the different forms of business entities. Thus all business owners are treated identically and the small business owners retain more capital.

CREATE A UNIFORM NEXUS STANDARD FOR INCOME TAX REPORTING TO STATES.

The emergence of e-commerce has made new markets more accessible to small business. The benefit of these new markets is often offset by myriad state nexus standards. These standards are being developed by various state initiatives, which have contradictory definitions and tax concepts. The compliance costs of these standards often eliminate profits. Small businesses are forced to stop sales or litigate their positions. Small business sales may be too small in a particular state to justify the cost of litigation. Thus, complying and paying the state income tax will be the easiest way to proceed. Otherwise, costly litigation or uncertainty can accompany the small business as it implements its plans.

Small business needs the Federal Government to guide the states in establishing uniform income nexus laws and "safe harbors." Therefore, it is recommended that the Federal Government, through Treasury Department regulations or recommended legislation, set standards establishing a uniform fair and consistent taxation scheme.

LEASEHOLD IMPROVEMENTS

Change present law governing the amortization of leasehold improvements over a 39-year life to a 10-year life. The 39-year amortization does not follow the pattern of most leases written today and most often creates large abandonment losses at the time a rental space is vacated and thus causes distortion in business decisions. Most small business leases are currently prepared with 5 to 10 years of duration. This change would bring the tax laws more in line with current business practices.

DISCLOSURE AND TRANSPARENCY OF ESTIMATIONS AND VALUATIONS

Congress enacts tax laws based on cost estimates provided by the Joint Committee on Taxation that can have a dramatic impact on small businesses' ability to attract or preserve business capital. In addition, the President and the Executive Branch propose new tax changes based on estimates from the Office of Tax Policy of the U .S. Department of Treasury that also can help or hurt capital access dramatically.

In order to assess the accuracy of these important estimates, and so that the Congress and the small business community can be fully informed of the basis for legislation, the assumptions and methodology of the estimates should be fully disclosed and available to the public prior to congressional action on the underlying proposal.

BRING THE CONTRIBUTION LIMITS FOR SIMPLE PENSION PLANS TO PARITY WITH SECTION 401(K) PLAN LIMITS

Simple pension plans have successfully increased retirement coverage for many small businesses' employees. The simplicity of forming the plans has allowed small business employers to offer increased retirement planning options to their employees. These employees may currently save for their retirement, but then do not have the ability under present inequitable law to save at the same level as participants in Section 401(k) plans that are generally offered by for larger businesses.

Simple pension plans may take the form of a Simple IRA plan or a Simple 401(k) plan. Elective deferrals for 2002 are limited to $7,000 for both styles of Simple plans. Participants in non-Simple 401(k) plans may make elective deferrals of $11,000. This differential puts small businesses at a competitive disadvantage in attracting employees who wish to maximize their tax deferred retirement contributions. The compensation and administration costs of having a non-Simple 401(k) plan are prohibitive to many small employers. Simple plan participants should be able to defer amounts similar to non-Simple 401(k) participants.

CHANGE THE DUE DATE FOR IRA CONTRIBUTIONS TO INCLUDE APRIL 15th EXTENSIONS

Under current law, all IRA contributions that are to be deducted from any year's income are due by April 15th of the following year. As a matter of equity with other retirement vehicles, the due date for the contribution should be the same as the tax-filing date including extensions. Many times the sole proprietor does not have the cash to pay the balance due, pay the first quarter's estimated tax payment, and fund an IRA all at the same time. Since retirement saving is a priority recognized by the Federal Government, the IRA contribution deadline should be extended. This will help business owners balance their short-term capital needs.

PERMANENT REPEAL OR IMMEDIATE RELIEF FROM ESTATE TAX

Congress has recognized the abject unfairness of the estate tax. Unfortunately, the failure to repeal permanently this "death tax" has created uncertainty in the business continuation plans of millions of small business owners. It is therefore urged that a permanent repeal of the estate tax be enacted.

Alternatively, recognizing that permanent repeal has been difficult to achieve, the credit from imposition of estate tax should be raised and made equivalent to $5 million and should be indexed for inflation. Such policies would preserve capital so that inter-generational businesses could continue. In the short term, this will also reduce the cost and amount of estate planning.

INTERNAL REVENUE CODE - UNEQUAL TREATMENT BETWEEN LARGE AND SMALL FIRMS

Recent reports focusing on the fairness of the tax system have analyzed various sections of the Internal Revenue Code as providing more favorable tax treatment for large businesses. The study was done by the Prosperity Institute for the National Small Business United organization, and it catalogues the unequal treatment of small business in major tax incentive programs. Congress should use this important document as a guide to legislate tax parity in the tax code between small businesses and large businesses.

LLCs SHOULD BE ABLE TO CREATE ESOPs WITH AN ERISA MODIFICATION

Employee stock ownership plans (ESOPs) are a benefit to small business and a source of capital. Many small businesses are either converting to or forming limited liability companies (LLCs). These companies cannot avail themselves of the ESOP benefits because LLCs ownership interests are issued in the form of units and not capital stock of a corporation. To remedy this inequity, we believe that the ESOP definition contained in the ERISA law should be expanded to include LLC units as if they were corporate stock. This gives businesses another avenue for raising capital within their preferred business structure.

TAXING SHORT-TERM VERSUS LONG-TERM GAINS

Stock market volatility has wreaked havoc in our financial markets. It has negatively impacted the investing public, employee retirement plans, and corporate management decision making. Too much of the daily stock market trading volume is controlled by institutional investors who focus on market speculation. These institutional investors generally experience no tax consequences resulting from their activities, and their short-term trading activities contribute very little to healthy economic productivity. Accordingly, the Forum recommends that the short-term trading profits of all entities, including individuals, corporations, tax-exempt and tax-deferred entities, be taxed at ordinary income tax rates. Taxes could be assessed at the entity level. We believe that such a provision would reduce the stock market volatility and raise additional revenues for the U.S. Treasury.

SMALL BUSINESS EXLUSION FROM THE LIMITATIONS UNDER INTERNAL REVENUE CODE SECTION 274

Small business capital is generated from revenue increases and expense reductions as well as direct capital raising. Also, access to the providers of capital is often described as, one-on-one or person-to-person, rather than through the mass media.

Marketing and advertising expenses for small businesses are proportionately less than big business direct marketing, advertising, and capital raising expenses in part

because small businesses use business meals and entertainment in place of more costly marketing and advertising. Therefore, in concurrence with the recommendations of the White House Conference on Small Business, we recommend that a full exclusion for business meals and entertainment be allowed for all small businesses under IRC Section 274.

REVISE INTERNAL REVENUE CODE SECTION 280F TO REFLECT REAL WORLD

For many small businesses, vehicles represent their largest capital outlays. Current tax policy encourages capital outlay through accelerated depreciation methods. Vehicles are the exception.

The "luxury" vehicle cost limit has not been adjusted since 1986. Passenger vehicles that are used in business must be used more than 50% of the time for business purposes in order to use MACRS depreciation. They are further limited as "listed property" to reduce the Section 179 expense deduction. Finally, luxury vehicles, those with cost in excess of $15,000, are additionally limited in their subsequent year MACRS deductions under IRC Section 270F(a).

The Forum commends the efforts of the Treasury and the IRS to look at the IRC Section 280F rules on listed property. Trucks and vans should be exempted from the listed property rules. These rules were established to thwart the rapid write-off of luxury vehicles. It serves no useful purpose to subject trucks and vans used in businesses to these restrictive and complex regulations. The exclusion for trucks and vans is based on weight rather than usage such that large SUVs escape the Section 280F limitations while lighter weight delivery vans do not. We believe that the IRS should:

1. administratively adjust the luxury cost to reflect current pricing; and
2. modify the definition of a passenger vehicle to exclude all delivery vehicles based on function rather than weight.

EDUCATION ASSISTANCE (INTERNAL REVENUE CODE SECTION 127) EXCLUSION

In order to survive and flourish in our rapidly evolving economy, continuing education is a necessary investment for the small business owner. IRC Section 127 encourages the development of businesses' human capital by allowing employers to provide employees up to $5,250 per year of educational assistance. The current IRC Section 127 limits the amount of educational assistance benefits available to shareholders and owners of small businesses and their spouses and dependents.

To create parity between large and small businesses, the language in IRC Section 127 limiting benefits to owners and shareholders should be deleted. Availability of this educational assistance employer deduction/employee income exclusion should be widely disseminated through print, broadcasting and electronic media.

SECURITIES REGULATION RECOMMENDATIONS

A. NEW RECOMMENDATIONS

This year's Forum adopted the following new securities regulation recommendations.

SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act of 2002 requires major changes in the corporate governance of many U.S. corporations. The Act applies to all public companies without regard to size. Several of the changes, if applied blindly to small businesses, would have a damaging effect on small businesses generally and on small businesses' access to the capital markets in particular. In order to further the SEC's mandate to promote capital formation, the SEC should seek a technical corrections bill to recapture the benefits of graduated requirements, as reflected in the long tradition of graduated standards appropriate for small businesses.

We also recommend that the SEC use its existing exemptive and other statutory authority to delay, or at least to defer or gradually phase in, the effective date of Sarbanes-Oxley provisions to not less than one year for "small business issuers," as defined in SEC Regulation S-B. During this deferral or phase-in period, the SEC should elicit comments and evaluate the economic and regulatory impact of the Sarbanes-Oxley Act on small business issuers and report such findings to Congress. During this time period, the SEC could also prepare rules and create and publish guidelines for compliance with the Sarbanes-Oxley Act. For the very smallest of SEC registrants (*i.e.*, "nano" cap companies with a market capitalization of less than $5 million), the SEC should provide a five-year schedule for gradual implementation of the Sarbanes-Oxley requirements.

There are inherent deterrents in this law to capital formation for small business. Many of the rules are arbitrary. For example, CPA partner rotation is no surety of quality audits. Small business CPA firms with only one audit partner will be effectively eliminated from public sector work, without regard to professional qualifications or industry expertise. Furthermore, the traditional client base that prefers the time and attention that they receive from these small business accounting firms will have to solicit the services of larger CPA firms. Additional costs and less personalized attention will result.

In regard to the prohibition on loans to officers, directors and other insiders, the SEC should define such loans to exclude cash advances for the following items: incidental expenses, such as travel, moving, and other normal and customary items; the payment of insurance premiums; and the cashless exercise of options and warrants. As regards the last item, the SEC should provide confirmation that the cashless exercise of options does not constitute an illegal loan under the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act has changed the definition and duties of "insider" and "outsider" for purposes of service on boards of directors. The result is counter to good corporate governance. For instance, a venture capitalist may find that his firm controls a significant percentage of a company. In such cases the VC would be an "affiliated director," and despite such VC having an interest aligned with common shareholders, the financial expertise, and an interest in good governance, the VC would not be able to serve on certain key board committees of the company, such as the audit committee. The smaller public companies are finding this to be a serious problem, as it makes it difficult to recruit qualified unaffiliated directors to these demanding positions. Therefore, we recommend that the definition of "affiliated director" be revised to exclude those who have significant equity ownership positions in the company but who have no executive authority, salary, or bonus compensation paid to such individual, apart from the compensation paid to all other directors.

In an effort to anticipate the requirements of Sarbanes-Oxley, the major stock exchanges have attempted to set their own standards for the "independence" of directors. The resulting multiple and conflicting standards are counter to the interests of many shareholders. We recommend that the SEC clarify the definition of "affiliated director" by meeting and coordinating with the exchanges to adopt a single measure or standard of director independence.

SECURITIES ACT OF 1933

We have observed a lack of consistency in the review of and comments on Form SB-2 registration statements from company to company. We recommend that the SEC provide additional training and supervision to its staff reviewers to ensure uniform application of review standards to small business filings. We also recommend that the SEC provide a senior level reviewer to the initial examination of a registration statement to identify any substantive issues on the first round of comments.

Rule 506 of Regulation D

The restrictions on the use of general solicitations to make offers and sales under Rule 506 to accredited investors should be eliminated or loosened. For example, the SEC should lift the ban on general solicitations for Rule 506 offerings where there is a pre-closing test for "accredited investors," and the issuer is not a reporting company under the 1934 Act.

The SEC should consider amending Regulation D to permit the use of Rule 134-type tombstone announcements in connection with Rule 506 offerings.

Integration

We recommend that the SEC provide additional guidance on the integration rules and the meanings of terms used in those rules in light of recent market events, particularly regarding public companies conducting private placements.

State Regulation

The SEC and NASAA should work together to expand the "intra-state" Rule 147 offering exemption to encompass a "regional" offering exemption.

SECURITIES EXCHANGE ACT OF 1934

Markets

We believe that "soft dollars" (*i.e.*, payments by an investment manager for research or other full-service brokerage services by directing a portion of its commission payments rather than through direct cash payments or "hard" dollars) and "payments for order flow" (*i.e.*, payments by a securities dealer to a retail broker to send it orders for execution) represent impairments on the efficiency of the securities markets. For the benefit and protection of investors, the SEC should reassess its positions with respect to soft dollars and payments for order flow with a view to prohibiting both.

The SEC should encourage the creation of a second-tier market on national stock exchanges to provide an auction market alternative to small capitalization companies.

The SEC should encourage the establishment of electronic and internet supported markets and matching systems to service the small public company market segment (nano-cap companies).

The Bulletin Board Exchange ("BBX")

The BBX proposal in its current form would replace the over-the-counter bulletin board ("OTCBB"), which is sponsored by the Nasdaq Stock Market, with a new BBX Stock Exchange. The proposal should not be cleared by the SEC without further study of the impact that the listing standards adopted by the BBX would have on investor protection and other small business regulatory issues. In this regard, the SEC should consider the following issues.

- The stock of many companies that currently trade on the OTCBB may become forced to trade in the Pink Sheets due to the inability of the issuing companies to meet the BBX listing standards. Once in the Pink Sheets, the issuing companies may no longer be required to be reporting companies under the 1934 Act. The more this group of companies that have been removed from

the OTCBB and forced into the Pink Sheets decides to drop out of the 1934 Act reporting system, the greater is the likelihood and potential for micro-cap fraud in their securities.

- The higher BBX listing standards will deter many new companies from voluntarily registering to become reporting companies under the 1934 Act that otherwise would have done so in order to satisfy the qualifications for quotation on the OTCBB. The proposal to replace the OTCBB with the BBX and the inability of many companies to satisfy the higher BBX listing standards will result in such companies simply opting to continue trading in the Pink Sheets and to forgo any incentive to become reporting companies under the 1934 Act.

- Many companies currently traded on the OTCBB are likely to lose substantial market value if forced to trade in the Pink Sheets because of their inability to satisfy all of the BBX listing standards. Historically, companies have lost significant market value when forced to withdraw from the OTCBB and subsequently trade in the Pink Sheets.

The SEC should prohibit the Nasdaq Stock Market from terminating the OTCBB, until such time as the Nasdaq Stock Market, working with the SEC and this Forum, can determine a suitable alternative to the OTCBB that would not be harmful to small business capital formation. If the BBX is adopted, the continued operation of the OTCBB will serve to protect investors in companies that would not otherwise qualify for the BBX and facilitate capital formation for some small businesses that need to have a viable trading market for their securities in order to raise capital successfully. Further, the SEC should assess the impact on small businesses currently traded on the OTCBB of any proposed changes in the structure and ownership of the Nasdaq Stock Market arising from the NASD's plans to conduct a public offering of its securities.

The SEC staff should withdraw the SEC telephone interpretation holding that the OTCBB is not an "automated quotation system" for the purpose of eligibility to use Form S-3 to register the resale of shares by selling stockholders.

All companies that are reporting under the 1934 Act, whether they trade on the BBX or the OTCBB, should be eligible to use Form S-3 for both primary and secondary (resale) offerings of securities. Under the Sarbanes-Oxley Act, these companies must certify as to their internal controls and to the disclosure, content and quality of their periodic reports. Accordingly, it seems reasonable to permit these companies to use the same periodic reports to keep both primary and resale prospectuses effective, unless and until the SEC determines upon review that the prospectus does not comply with the requirements of the 1933 Act.

Securities of companies that are listed on the BBX should be exempted from the SEC Penny Stock Rules.

Regulation of Investor "Finders"

The SEC should better define the term "broker-dealer" by explaining what kind of activity does and does not require registration as a broker-dealer.

The SEC should establish a scheme of broker-dealer regulation for so-called "finders," as set forth in the Mission Statement of the Small Business Forum Ad Hoc Group Proposal on Finder Registration and Regulation (included as Tab 14 of this year's Forum materials). The SEC should work with this Ad Hoc Group, NASAA and the NASD to achieve the objectives set forth in the Mission Statement and implement the recommendations of the report.

The SEC should consider exercising its rulemaking authority to create a *de minimis* safe harbor exemption from the definition of the term "broker." For example, a person not otherwise engaged in the securities business, but receiving payment, which may include a success-based fee, for less than a fixed number of transactions over a given period of time should not be considered by the SEC to be in the business of effecting transactions in securities for the accounts of others, and consequently should not be considered by the SEC to be acting as a "broker."

Disclosure Requirements

The SEC should amend the disclosure requirements of Forms 10-KSB and 10-QSB to add a table that lists and identifies all Forms 4 filed by insiders during the reporting period and all insider shares becoming eligible for public market resale.

INVESTMENT MANAGEMENT ISSUES

The SEC should develop a user-friendly handbook on the implementation and operation of business development companies ("BDCs").

The SEC should designate a member of its staff to help companies through the BDC registration process.

EDGAR

The SEC should address text filing issues raised by small business filers using the "Extensible Business Reporting Language" ("XBRL") of the SEC's EDGAR (Electronic Data Gathering Analysis and Retrieval) system. XBRL is almost a certainty for the future of the EDGAR system. Third party vendors are already responding to investor demand and selling some EDGAR filings converted to XBRL. In implementing an XBRL filing requirement, it is likely that the cost of compliance will be material to small businesses and that failure to make XBRL filings will make it difficult for small businesses to attract a secondary market. Given such significant potential consequences

to small businesses, and in an effort to define the optimal standards for the SEC's central reporting system, the SEC should study this matter and adopt probable standards and implementation timelines for XBRL.

The EDGAR system should be modified to include a PDF (Portable Document Format) option for filings.

SEC SMALL BUSINESS ADVOCACY PROGRAM

The SEC should establish an Office of Small Business Advocacy that cuts across internal Division lines.

The Chairman of the SEC should designate one SEC Commissioner as Small Business Liaison Commissioner.

The SEC should evaluate the SBA's advocacy program and modify its own SEC small business ombudsman program to capture the strengths of the SBA advocacy program.

FUTURE FORUMS

All future SEC Government-Business Forums on Small Business Capital Formation should be held in Washington, D.C. to get maximum participation from the SEC staff and the staff of other Federal Government entities. Invitations should go to other appropriate agencies to have their staff attend and participate in the Forum. Set a fixed date for the Forum every year.

A panel of attorneys, accountants, business owners and other advisors should make a presentation at the 2003 Forum on registration statements filed by small business issuers with the Commission and other small business issuer related topics. The disclosure and accounting reviewers of small business filings from the Office of Small Business Disclosure of the SEC's Division of Corporation Finance should be invited and urged to attend to have the opportunity to meet with small business issuers and their advisors. This will provide an opportunity for the small business community to meet with the SEC staff who review their filings.

Next year's Forum should have an investment management panel that deals with small business issues rather than large business issues. In particular, the panel should address the availability to community development venture capital funds of exemptive orders for closed-end investment companies that raise less than $10 million under the provisions of Section 6(d) of the Investment Company Act of 1940, and Rule 6d-1 thereunder.

A mechanism should be developed to identify the issues to be pursued well in advance of the Forum, giving a chance for advance consideration by all participants and the chance for academic or other studies to be done and presented at the Forum. For example, the issue of an anti-fraud insurance fund could be identified for next year's Forum with the opportunity for academic or other studies to be presented at the Forum on this topic.

Lap top computers and printers should be available to each of the breakout groups of the Forum to facilitate the finalizing and compiling of their recommendations to be included in the Annual Final Report of the Forum.

The Executive Committee of the Forum should be restructured or rejuvenated, as follows:

- Start from scratch;
- Limit terms to three years with staggered terms;
- Anyone who wants to be on the Executive Committee must volunteer;
- The Executive Committee should be selected from such volunteers;
- Consideration should be given to encouraging new members to participate in the Executive Committee, particularly from past Forum participants;
- Encourage the Executive Committee to be more pro-active in planning and implementing recommendations throughout the entire year;
- A quarterly report should be presented to the members of the Executive Committee;
- Consider creating a non-SEC person as Co-Chair of the Executive Committee; and
- The Executive Committee should meet as early as possible, certainly well before April 2003.

E-mail addresses of all participants at the Forum should be made available to all participants.

- Set up a "listserv" of e-mail addresses of all the Forum participants to be hosted by the CEO Council.

- The Final Report of the SEC Government-Business Forum on Small Business Capital Formation, including the Forum's final recommendations, should be e-mailed to all participants as soon as the listserv is established. This Final Report of the Forum should be officially posted, as soon as practicable, on the SEC web page at: http://www.sec.gov/info/smallbus/sbforum.shtml.

- A small committee of Forum participants should be appointed as "point persons" to interface with the SEC staff on a regular basis concerning each recommendation of the Forum. These point people should use the listserv to communicate regularly with Forum participants concerning the SEC's actions with respect to each recommendation.

- All materials for the Forum for 2003 should be sent electronically via e-mail as soon as available. The SEC need not wait until all material is available. Rather, each handout should be sent as soon as available. There is no need for the large book of written material to be passed out at the date of the Forum.

B. PRIOR RECOMMENDATIONS RE-ADOPTED

In addition to the new recommendations discussed above, this year's 2002 Forum participants also re-adopted all of the securities regulation recommendations of last year's 20th Annual SEC Government-Business Forum held in September 2001.

SECURITIES ACT OF 1933

Offer Regulation

The regulatory focus for private offerings should be on sales, not offers. In this regard, general solicitations should be permitted in private offerings at least where:

- a disclosure document is used or required; and
- the sale does not close (or right of rescission exists) for x days after receipt of the disclosure document.

The restrictions on the use of general solicitations to make offers and sales under Rule 506 to accredited investors should be eliminated.

Integration

The SEC should revise the integration provisions of Rule 502(a) by replacing the six-month integration test with a two- or three- month test as follows:

> Offers and sales that are made more than two [or three] months before the start of a Regulation D offering, or are made more than two [or three] months after the completion of a Regulation D offering, will not be considered as part of that Regulation D offering, so long as ....

The SEC should reconsider the integration rules under Rule 502 to eliminate the present safe harbor time requirements and apply only the five-part test to subsequent offerings when the prior offering has not clearly terminated.

Existing Registration Exemptions

The SEC should amend Regulation A to:

- return the review process to regional offices;
- increase the aggregate dollar limit from $5 million to $10 million;

- for those issuers intending to raise over $5 million, adopt the following financial statement requirements to replace current requirements (issuers seeking $5 million or less would comply with the current financial statement requirements):

    1. historical financial statements must at a minimum be reviewed in accordance with SAS 71 and be accompanied by an accountant's review report; and

    2. forecasted financial statements, if forecasts are included, must at a minimum be compiled by an independent public accountant and must support the registrant's sources and uses of funds calculations.

The SEC should shorten the aggregation periods in rules promulgated under Section 3(b) from twelve months to six months, and increase the aggregate dollar amount to, for example, 1.5 times the rule's current dollar limit.

The SEC should revisit the current dollar ceilings under all Section 3(b) exemptions.

The SEC should increase the ceiling of Rule 504 to $5 million.

New Exemption from Registration

The SEC should exempt all transactions of less than or equal to $2,500 per investor, per issuer, provided that the investment is less than or equal to 10% of the investor's net worth.

Disclosure Guidance

The SEC should create a small business issuer manual similar to the "Accounting Manual" prepared by the Division of Corporation Finance. This manual should include a list of the most representative comments issued by the Division of Corporation Finance, including comments issued with respect to certain line item requirements, as well as general disclosure issues.

The SEC should create a task force to design a prospectus with a view towards increasing the readability of the document. The following are suggestions:

- improve the design of the prospectus to appeal to the reader;

- make the prospectus look more like an annual report or a magazine; and

- encourage, for example, greater use of graphics, color, different type fonts, white space and greater freedom to place disclosure sections at different locations in the prospectus.

There is a great deal of uncertainty regarding how issuers can conduct concurrent private and public offerings, including private equity lines and PIPES. The Forum recommends that the SEC develop guidance with regard to the following matters:

- the requirements to structure a valid Section 4(2) exempt transaction;
- the definition of "at market risk"; and
- an analysis of what constitutes a general solicitation, if the requirement is not eliminated, as suggested above.

State Regulation

The SEC should create ongoing dialogue with the states to facilitate use of the Regulation A exemption at the state level.

In an effort to eliminate the duplication of the state and federal disclosure review processes, each state should adopt a rule to provide that if an offering receives a full disclosure review by the SEC, the state will not raise disclosure comments for that offering.

SECURITIES EXCHANGE ACT OF 1934

Regulation of Finders

The SEC should work on forming a self-regulatory organization for capital finders, such as the National Association of Capital Finders (NACF).

- The NACF would administer the licensing of capital finders and then "police" their activities. Capital finders would be required to take an exam that covers:
    1. capital structure and formation; and
    2. knowledge of the securities laws as they pertain to disclosure and fraud.
- The SEC should work on standard conduct provisions, such as:
    1. finders may not handle funds;
    2. finders may not negotiate; however, they may present investment terms set by the issuer;
    3. finders may charge success fees; and

4. there must be available a private placement memorandum with at least the following information:

    a. material terms of the transaction, such as the amount being raised, the type of security (*i.e.*, common, preferred, etc.) and the percentage of the issuer's securities being offered to investors;

    b. description of the issuer's business;

    c. use of proceeds;

    d. risk factors;

    e. capitalization table; and

    f. description of management.

Application of Broker-Dealer Requirements

A person, who in exchange for a fixed fee, provides a list of investors who have stated in writing that they are accredited investors, should be exempt from the broker-dealer requirements.

The SEC should create a *de minimis* exception to the definition of a broker-dealer, along the lines as provided in some states, such as Illinois, to facilitate casual finder activity.

The SEC should create a limited broker-dealer licensing category for financial intermediaries who are not registered through a broker-dealer firm within the following parameters:

- NASD membership required;
- abbreviated application form;
- lower fees for application and renewal;
- appropriate testing requirements;
- applicants must certify that there are no "bad boy" disqualifications;
- annual renewal of registration;
- no custody of client funds or securities permitted;
- no minimum net capital requirements;

- appropriate bonding requirements;
- explicit recognition that these persons may accept transaction-based remuneration;
- no discretionary authority permitted;
- record-keeping appropriate to the business; and
- applicable sales practice rules.

The states should exempt from the definition of "agent" those sales representatives that do not receive compensation for selling securities. This amendment could be addressed in the Uniform Securities Act, so that officers, directors and employees of companies, so long as they do not receive sales compensation, would not be considered as "agents."

Rule 15c2-11

The SEC should develop an exemption from Rule 15c2-11, if the issuer:

- has at least one class of securities registered under Section 12(g);
- is current in its filings; and
- is not subject to any disqualifying provisions under Rule 262 of Regulation A.

The SEC should propose to the NASD that it revise its Form 211 application process to permit issuers to file and participate in the defense of such applications.

INVESTMENT COMPANY ACT OF 1940

Relief from 1940 Act Regulation

The SEC should develop an Enterprise Zone Business Development Corporation concept susceptible to special treatment under the 1940 Act.

The SEC should create an exemption under the 1940 Act for Small Business Investment Companies licensed by the U. S. Small Business Administration.

The SEC and the SBA should conduct a joint study to determine if the 1940 Act regulation of small business investment companies licensed with and regulated by the SBA is necessary for the protection of investors.

The SEC should expand the definition of "qualified purchaser" under the 1940 Act to include "accredited investor" as defined in Rule 501(a) of Regulation D under the 1933 Act.

> The purpose of this revision is to expand the pool of potential investors for private funds. The goal is to determine a way to encourage (or require) the top tier venture capital arrangement firms (those operating investment companies under Section 3(c)(1) or 3(c)(7) of the 1940 Act) to manage capital from retail non-accredited investors side-by-side on a mirror basis with existing pools of capital.

The SEC should provide regulatory relief from the 1940 Act by permitting an investment company, managed by a venture capital fund manager with more than $500 million from institutional clients, to be exempt from the 1940 Act and to report as an operating company under the 1934 Act.

Congress should provide tax incentives to fund managers to encourage them to manage both institutional capital and small investor capital at the same time and on the same terms.

Miscellaneous

The SEC Office of Small Business Policy should coordinate with the National Conference of Commissioners on Uniform State Laws in its efforts to rewrite the Uniform Securities Act.

The SEC should expand the focus of the Office of Small Business Policy to include representatives of the Divisions of Enforcement, Investment Management and Market Regulation, and/or create a task force to explore the possibility of creating a new Division of Small Business at the SEC.

Private Sector Forum Participants

Martin Abo
Abo & Company, LLC
Plaza 1000 At Main Street
Suite 403
Voorhees, NJ 08043

William Alsover
Centennial SEC Co.
3075 Charlevoix Dr.
Grand Rapids, MI 44546

Barry H. Barnett
Barnett & Keating
PO Box 6584
Albuqueque, NM 87197-6584

Jeffrey A. Baumel
McCarter & English, LLP
Four Gateway Center
100 Mulberry Street
Newark, NJ 07102

William M. Beatty
NASAA
Washington Securities Division
PO Box 9033
Olympia, WA 98507-9033

Eric Blackledge
Oregon Small Business Council
233 SW 2nd Street, PO Box 639
Corvallis, OR 97339-0639

Kenneth C. Blair, Jr.
Circle Transport & KB Services
PO Box 243
Newbury, OH 44065

Charles H.B. Braisted
Attorney at Law
167 Orchard Run
Cornwall, VT 05753-9816

Julius J. Brecht
Wohlforth Vassar Johnson & Brecht
900 West 5th Avenue, Suite 600
Anchorage, AK 99501

Stephen Brock
GoPublicToday.Com, Inc.
1701 Valoma Street
Las Vegas, NV 89102

Francisca O. N. Brodrick
Bonf International Enterprises
1964 First Avenue, Suite #2-Z
New York, NY 10029

Susan D. Ciallella
Cozen O'Connor
1900 Market Street
Philadelphia, PA 19103

Ron Claiborne
DC Securities Bureau
DC Department of Insurance and
Securities Regulation
810 First Street, NE, Suite 701
Washington, DC 20002

Cecilia A. Cordova
DEMCO Law Firm, P.S.
5224 Wilson Ave. S.
Suite 200
Seattle, WA 98118

Sam Cordovano
Cordovano & Harvey PC
201 Steel Street, Suite 300
Denver, CO 80206

Timothy F. Cox
NASAA
Maryland Attorney General Office
200 St. Paul Place
Baltimore, MD 21202-2020

Armand R. Dauplaise
1630 Winter Springs Blvd.
Winter Springs, FL 32708

Roger V. Davidson
Ballard Spahr Andrews & Ingersoll, LLP
1225 17th Street, Suite 2300
Denver, CO 80202-5596

Leonard S. DeFranco
DeFranco & Associates
2311 W 22nd Street, #217
Oak Brook, IL 60523

Ralph V. De Martino
De Martino Finkelstein Rosen & Virga
1818 N Street, NW, Suite 400
Washington, DC 20036

A. Louis Denton
Philadelpha Corporation for
Investment Services
1650 Market Street, Suite 3050
Philadelphia, PA 19103

Carl N. Duncan
5718 Tanglewood Drive
Bethesda, MD 20817

James H. Ellis
The Mutual Fund Counsel Tiny Group
36 Butler Road
Scarsdale, NY 10583

William D. Evers
Foley & Lardner
California Capital Access Forum
One Maritime Plaza, 6th Floor
San Francisco, CA 94111

L. J. Fay
Alpha Management Group Inc.
897 Cayo Grande
Thousand Oaks, CA 91320-1946

Edward H. Fleischman
Linklaters
1345 6th Avenue, #1900
New York, NY 10105

Richard C. Fox
Fox Law Offices, P.A.
Molino Lane, PO Box 1097
Pecos, NM 87552

Peter Friedman
Peter Friedman, CPA
37 Church Street
Keene, NH 03431

Lawrence H. Gennari
Gadsby Hannah LLP
225 Franklin Street
Boston, MA 02110

Gregory M. Giammittorio
Shaw Pittman LLP
1650 Tysons Boulevard, Suite 1400
McLean, VA 22102

Philip Feigen
Patton Boggs
2550 M Street, NW
Washington, DC 20037

Robert W. Goehring
Robert W. Goehring & Associates
310 Grant Street, Suite 404
Pittsburgh, PA 15219

Webster L. Golden
Stevens & Brand, LLP
PO Box 189
Lawrence, KS 66044

Joseph M. Golemme
Joseph M. Golemme, CPA
89 Shrine Road
Norwell, MA 02061

Neil E. Grayson
Nelson Mullins Riley & Scarborough
999 Peachtree Street, NE, #1400
Atlanta, GA 30309

Earl Hall
Parkway Enterprises Inc.
831 Parkway Avenue, B-9A
Trenton, NJ 08618

Gregory J. Halpern
Circle Group Internet
1011 Campus Drive
Mundelein, IL 60060

Scott W. Hatfield
S.W. Hatfield, CPA
PO Box 820395
Dallas, TX 75382-0395

Fernando Hernandez
Hernandez De La Rosa
Hernandez-Ojeda, S.C.
Guillermo Gonzalez Camarena
No. 1600-4 piso
Col. Santa Fe, Mexico 01210 D.F.

Mark T. Hiraide
Petillon & Hansen
21515 Hawthorne Boulevard
Suite 1260
Torrance, CA 90503

Victor Hollander
Good Swartz Brown & Berns, LLP
11755 Wilshire Boulevard, 17th Floor
Los Angeles, CA 90025

Preston B. Kavanagh
Conning Capital Partners
185 Asylum Street
Hartford, CT 06103

Harold P. Kocher
North Dakota Securities Department
600 East Boulevard
Bismarck, ND 58506

Barbara K. Kravitz
Kravitz & Company Limited Inc.
No. 8 Saint Cyr Drive
Hampton, NH 03842

Michele A. Kulerman
Hogan & Hartson, LLP
555 Thirteenth Street, NW
Washington, DC 20004

Gerald J. Laporte
3154 N. Key Blvd.
Arlington, VA 22201

Marc Lumer
Marc Lumer & Company
221 Main Street, Suite 735
San Francisco, CA 94105-1919

John C. Malone
Malone & Bailey, PLLC
5444 Westheimer Road, #2080
Houston, TX 77056-5396

Robert C. Mangone
Fox Horan & Camerini LLP
825 Third Avenue
New York, NY 10022

John W. Martin
Law Office of John W. Martin
5777 West Century Boulevard
Suite 1540
Los Angeles, CA 90045

Judith E. McCaffrey
McCaffrey & Raimi, P.A.
5811 Pelican Bay Boulevard
Suite 206-A
Naples, FL 34108

William P. McKeithan
AIMR
560 Ray C. Hunt Drive
Charlottesville, VA 22903

Gary McKinsey
Grimbleby Coleman, CPA's
817 Coffee Road #B
PO Box 972
Modesto, CA 95353

Anna S. Mills
Van Winkle, Buck, Wall, Starnes
& Davis, P.A.
PO Box 7376
Asheville, NC 28002

Martin Mushkin
Pomeranz Gottlieb & Mushkin, LLC
205 Lexington Avenue, 16th Floor
New York, NY 10016-6022

Lynn D. Naefach
Pennsylvania Securities Commission
1010 N. Seventh Street
Harrisburg, PA 17102

Jim Oakley
Oakley Company
PO Box 1947
Porterville, CA 93258-1947
559-781-9262

Gerard P. O'Connor
Foley Hoag LLP
155 Seaport Boulevard
Boston, MA 02210

James B. Parsons
Parsons Law Firm
500 108th Avenue, NE, #1710
Bellevue, WA 98004

J. Paula Pierce
The Pierce Law Practice
Box 7961
Charlottesville, VA 22906-7961

Irwin Pomerantz
Irwin Pomerantz & Associates
50 North La Cienega Boulevard
Suite 203
Beverly Hills, CA 90211

Mariana Prieto
Foley Hoag
155 Seaport Boulevard
Boston, MA 02210-2600

Edith Quick
Quick Tax & Accounting Service
2536 Via-Miralesta Drive
St. Louis, MO 63125-3415

Roy Quick
Quick Tax & Accounting Service
2536 Via-Miralesta Drive
St. Louis, MO 63125-3415

Jay S. Rand
Morrison & Foerster
1290 Avenue of the Americas
New York, NY 10104-0050

Alfred Reeves
Farrand Investment Bankers
7100 W. Camino Real
Suite 402
Boca Raton, FL 33433

Janet K. Risher
P.O. Box 250
Rancho Santa Fe, CA 92067

Alfred Rusch
DC Securities Bureau
DC Department of Insurance and
Securities Regulation
810 First Street, NE, Suite 701
Washington, DC 20002

Allison Salke
Gordon & Co.
One Gateway Center
Newton, MA 02458

John R. Sarkisian
PSA Security Systems
1570 W. Mission Boulevard
Pomona, CA 91766

Michael R. See
Assistant Chief Counsel
U.S. Small Business Administration
Office of Advocacy
409 Third Street SW, Suite 7800
Washington, DC 20416

Bruce W. Shewmaker
Crossbow Ventures
12 Briarwood Drive
Short Hills, NJ 07078

Wayne E. Silverman
Manning Silverman & Company
175 Olde Half Day Road
Lincolnshire, IL 60069

Brad Smith
WBS&A, Ltd.
3 Glenway Drive
Austin, TX 78738

Derrick Smith
1817 Drifters Peak
Las Vegas, NV 89144

Tom Stewart-Gordon
SCOR Report
4131 Fawn Hollow Drive
Dallas, TX 75244

Glen W. Sturm
Nelson Mullins Riley & Scarborough
999 Peachtree Street
Suite 1400
Atlanta, GA 30309

Michael Trokey
Michael Trokey & Company, P.C.
10411 Clayton Road
St. Louis, MO 63131

Garrett Vogel
Garrett Vogel, CPA
3767 Forest Lane, Suite 124
Dallas, TX 75244

Cletha A. Walstrand
Cletha A. Walstrand, PC
8 East Broadway, Suite 609
Salt Lake City, UT 84111

Joani Ward
Associate Supervisor
Public Offering Review
Corporate Financing Department
NASD Regulation, Inc.
Rockville, Maryland

Daniel D. Weston
League of American Investors
2804 Camino Dos Rios # 205
Newbury Park, CA 91320

Grafton H. "Cap" Willey, IV
Rooney Plotkin & Willey
10 Dorrance Street
Providence, RI 02903

Michael T. Williams
Williams Law Group, P.A.
2503 W. Gardner Court

Tampa, FL 33611
Cynthia Wong
Powell Goldstein Frazer & Murphy, LLP
1001 Pennyslvania Avenue, NW
Washington, DC 20004

James Young
The Legal Center
One Riverfront Plaza
Newark, NJ 07102

(participant unidentified)
Circle Group Internet, Inc.
Operating Account
1011 Campus Drive
Mundelein, IL 60060