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Revised

August 31, 2005

SEP 07 2005
OFFICE OF THE SECRETARY

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-9303

Re: Request for Public Input by Advisory Committee on Smaller Public Companies; File No. 265-26, 70 Fed. Reg. 45446 (August 5, 2005).

Dear Mr. Katz:

The American Bankers Association[1] ("ABA") appreciates the opportunity to comment on the current securities regulatory system for smaller companies, including the impact of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "the Act") on the system. In response to the request for public input by the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies (hereinafter referred to as the "Committee"), we respectfully submit these comments with particular focus on community banks and savings associations (hereinafter collectively referred to as "banks").

At the outset, the ABA would like to take this opportunity to endorse wholeheartedly the Committee's recent recommendations to the Commission.[2] Specifically, the Committee has recommended that the Commission delay Section 404 reporting requirements for non-accelerated filers for an additional year. As we discuss below, Section 404 of Sarbanes-Oxley requires management to report on internal control over financial reporting. This section, more than any other section of Sarbanes-Oxley, has caused public companies to incur huge regulatory burdens. Delaying Section 404 reporting requirements for an additional year for non-accelerated filers[3] will allow companies additional time to benefit from the guidance put forth earlier this year by the Commission and the Public Company Accounting

[1] The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

[2] Letter from SEC Advisory Comm. on Smaller Public Companies, to Christopher Cox, Chairman, SEC (Aug. 18, 2005) *at* http://www.sec.gov/info/smallbus/acspc/coxacspcletter081805.pdf.

[3] A non-accelerated filer is an issuer that does not meet the definition of an "accelerated filer" as provided in Rule 12b-2, 17 CFR 240.12b-2. Among other things, an accelerated filer has an aggregate market value of voting and non-voting common equity of $75 million or more.

Oversight Board ("PCAOB"), as well as any forthcoming rule changes recommended to the Commission by the Committee. In addition, efficiencies developed through accelerated filer compliance will generally inure to the benefit of non-accelerated filers.

While we strongly support this recommendation, the ABA notes that for all practical purposes, the recommendation, if adopted by the Commission, is meaningless for many community banks, whose market capitalization is approaching $75 million. Consequently, we would urge that the definition of non-accelerated filer be revised significantly to provide meaningful relief for these smaller public companies.

The Committee has also recommended that the Commission permanently exempt smaller public companies from complying with its accelerated filing time periods for filing annual reports on Form 10-K and quarterly reports on Form 10-Q. The Committee has generally defined smaller public companies as those with less than $700 million in market capitalization. If the Commission were to adopt the Committee's recommendation, smaller public issuers would have 75 days, rather that 60, to file annual reports and 40 days, rather than 35, to file quarterly reports.

The ABA specifically recommended that this action be taken when it testified before the Committee earlier this year. Often, small banks have only one person charged with regulatory reporting for the company. In addition to having responsibility for filing Forms 10-K or 10-Q, this person may also be responsible for filing, on a quarterly basis, call reports with the primary bank regulator, and perhaps holding company reports with the Federal Reserve Board. Furthermore, this person is often tasked with internal reporting, general accounting matters, interest rate sensitivity analysis and investing.

Many community banks can little afford the information technology to compile these periodic reports in an automated fashion. Consequently, many of these documents are compiled using manually created spreadsheets. Shortening the current filing requirements for reports required under the Securities Exchange Act of 1934 ("Exchange Act") will present additional personnel and increased technology expenses. Although we understand the Commission's desire for early filings, we believe that the increased costs are not justified for smaller companies. Consequently, we are extremely pleased that the Committee has agreed with our recommendation to exempt permanently smaller public companies from being subject to these accelerated filing requirements.

General Impact of Sarbanes-Oxley Act

As the Committee is aware, the Sarbanes-Oxley Act imposes considerable financial and opportunity costs on smaller public companies. Direct financial expenditures for audits, legal services, and liability insurance have all increased—expenditures that are ultimately borne by the company's shareholders. For example, one of our member banks reported that the bank had spent as much as six percent of its revenues on complying with the Act alone. By far the greatest increase has come from auditing expenses, especially for smaller companies with revenues of less than $1 billion. According to a Foley & Lardner study, small company auditing expenses rose by 96 percent from 2003 to 2004.[5] However, for firms with more than $1 billion in revenues, the increase in auditing fees rose a significant, but more modest, 58 percent. Clearly, auditing fees have risen in all cases, but have had a disproportionate impact on smaller companies.

In response to growing responsibilities, director and officer liability insurance and compensatory fees have also increased. According to Grant Thornton's Eleventh Annual Survey of Community Bank Executives, three-fourths of the responding community banks experienced an increase in their liability insurance.[6] Costs associated with added liability insurance expenses are again ultimately borne by the community bank's shareholders.

Legal costs associated with complying with the Act have also increased. As a result of Sarbanes-Oxley, public companies have had to hire additional legal counsel to assist them in drafting committee charters, corporate governance principles, codes of ethics, director independence surveys, and board of director and committee assessments. While no one would dispute that these documents are important in ensuring director independence and focusing director and senior management on their respective responsibilities, the new costs associated with preparing these documents, particularly for smaller public companies, should not be overlooked.

The Act has also imposed significant opportunity cost on banks by dampening the growth of business and diverting staff from their regular responsibilities. For example, some banks, wishing to expand their business by opening new branches, have determined that they cannot afford the regulatory costs that would follow the initial public offering needed to raise the requisite capital for expansion. Still other banks have had to sacrifice developing and providing new products for their customers to channel resources toward compliance with the Act. Furthermore, staff at community banks are spending an extraordinary amount in ensuring compliance with the Sarbanes-Oxley Act—time that might have otherwise been spent on meeting with new and existing customers and developing products and services for those clients. According to the aforementioned Foley & Lardner study, "lost productivity" from compliance with Sarbanes-Oxley cost an average of $1 million for companies with revenues under $1 billion.[7]

Given these enormous financial and opportunity costs, the Sarbanes-Oxley Act has clearly influenced smaller public companies and their decisions to become or remain a public company. In response to rising costs, many small institutions have publicly announced their decision to "go private" by reducing the number of shareholders of record to less than 300. Once "deregistered", these private

[5] Foley & Lardner, The Cost of Being Public in the Era of Sarbanes-Oxley, p. 12 (June 16, 2005), *available at* http://www.foley.com/news/news_detail.aspx?newsid=1270.

[6] Grant Thornton, Eleventh Annual Survey of Community Bank Executives (Feb. 24, 2004) *available at* http://www.grantthornton.com/content/96892.asp.

[7] Foley & Lardner, *supra* note 5, at 1.

companies may avoid complying with some of the more onerous corporate governance provisions of Sarbanes-Oxley, most specifically Section 404's requirement for management assessment of internal controls, but often at the expense of reduced resources available for expanding their business and reaching more customers.

This situation is particularly true for the banking industry. Since January 2003, ABA estimates that forty-one banks and eighteen savings institutions have reduced the number of shareholders of record to below 300 in order to become private companies.[8] In many cases, the banks and savings institutions, particularly those with low trading volumes, have explicitly stated that the cost of complying with Sarbanes-Oxley and the concomitant decrease in earnings per share no longer justified remaining publicly traded. Interestingly, many of these banks and savings associations pledged to continue to have their financial statements audited and to make quarterly and annual financial information available to the public. These banks were not trying to avoid public disclosure, but, rather, excessive corollary costs.

Community banks are, however, generally reluctant to engage in the stock buybacks required to reduce the number of record holders to below 300. As Daniel Blanton, President and CEO of Georgia Bank Financial Corporation, testified before the Committee on June 17, 2005:

> We are reluctant to [de-register] because the Bank was founded on the belief that the Augusta [Georgia] area needed a locally owned and operated, relationship-based bank. Most of our shareholders live within our market and all but a few do some business with the bank. This localized ownership is quite common at community banks across the U.S. Often times, investing in the local bank is the only remaining investment members of a community can still make.[9]

For those community banks that cannot reasonably go private due to a large shareholder base, many are forced to merge with a larger partner in order to spread out the cost of compliance. This merger option denies the investor the chance to invest in a local small business because, often times, the acquiring company is located some distance from the local community. In these situations, the community suffers a double blow in that the community loses a local business in which to invest and also local jobs, as the out-of-area acquirer consolidates headquarter operations away from the local community.

For this reason, the ABA previously advocated[10] that the Commission revise the shareholder threshold for registration under Section 12(g) of the Exchange Act. For the banking industry, the $10 million asset threshold is inconsequential, because

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[8] Search of EDGAR Database, SEC (Aug. 12, 2005) (search for records containing "SC 13e3" and SIC numbers: "6021", "6022", "6029", "6035", and"6036").

[9] R. Daniel Blanton, Oral Statement Before the SEC's Advisory Committee on Smaller Public Companies (Jun. 17, 2005) (transcript available from the Am. Bankers Assoc.).

[10] See Letter of March 31, 2005, from Wayne A. Abernathy, ABA, to William H. Donaldson, Securities and Exchange Commission.

99 percent of all banks have assets in excess of $10 million. Without intention to offer shares publicly, many community banks have seen their shareholder base grow as successive generations distributed their stock holdings among their descendents.

While the asset size parameter has been incrementally increased from the $1 million level initially required in 1964 to $10 million in 1996, the 500-shareholder threshold has never been adjusted. Yet, because the $10 million asset threshold is inconsequential, the 500 shareholder parameter is the critical criterion for determining which banking organizations are subject to the Exchange Act reporting requirements. This current indicator of a public market should be increased to some level between 1,500 to 3,000 shareholders. This level would appropriately establish a registration threshold comparable to the one enacted in 1964. The 300 shareholder of record requirement for de-registering should be revised to somewhere between 900 to 1,800 shareholders of record.

In this regard, we understand that the Committee is considering revising the current shareholder threshold to measure the number of beneficial shareholders,[11] as opposed to record holders. We believe this revision would be a grave mistake. A survey of ABA's Community Bankers Council revealed that many community banks have a significant number of beneficial owners, not all of whom beneficially hold through company-sponsored 401(k) or ESOP plans. Consequently, any determination to move from record to beneficial ownership for counting shareholders for Section 12(g) registration purposes could force into the periodic reporting system many banks that currently are not in the system. Such a result would be totally contrary to the position the banking industry has advocated before the Commission and the Committee.

The ABA would also note that any move to count beneficial, and not record, ownership is inconsistent with the Commission's own shareholder communication rules which give beneficial owners the right to withhold identifying information from issuers. Many banks that hold securities in nominee name report that beneficial owners rarely approve the release of identifying information to issuers.

<u>Sarbanes-Oxley Section 404/Internal Controls/Accounting/Auditing</u>

The banking industry has had significant experience with management reporting on internal controls and auditor attestations. The FDIC Improvement Act of 1991 (FDICIA) and the corresponding banking regulations have long required this type of reporting for banks with total assets of $500 million and more. Given our industry's extensive experience, we can offer many useful comments on the Section 404 process, because many of these provisions of Sarbanes-Oxley were modeled on the FDICIA requirements. We note that the FDIC, which is responsible for FDICIA reporting regulations, has recently proposed that the threshold be raised for internal control reporting.[12] If finalized, such reporting would only be required for banks over $1 billion in total assets rather than $500

[11] We use the term "beneficial ownership" to mean equitable ownership, not ownership where the holder has the right to vote the security or exercise investment discretion. See Rules 13d-3 and 14b-2, 17 CFR 240.13d-3 and 240.14b-2.

[12] 70 Fed. Reg. 44293 (Aug. 2, 2005) (to be codified at 12 CFR Part 363).

million. Although this proposal does not affect the Commission and Section 404 reporting, it illustrates the banking regulators' interest in regulatory relief for community banks. We do, however, strongly encourage the Committee and the Commission to similarly consider permanently exempting small public companies from Section 404 requirements. For example, all companies with less than $700 million in market capitalization might be the appropriate measure of a smaller public company exempt from both accelerated filing of Forms 10-K and 10-Q and from Section 404 requirements.

In addition to re-thinking the need to be a publicly-traded company, many small banks are being forced to incur huge new expenses associated with complying with Section 404, despite the fact that banks have been subject to similar FDICIA requirements since 1991. For example, while many community banks prefer to use the accounting firm with which they have long dealt because of its banking expertise, the costs have in many cases become prohibitive. This unintended consequence of Section 404 often forces smaller institutions to hire an audit firm with less banking experience generally and less familiarity with its particular business model.

The biggest challenge for community banks is meeting the staffing needs for Section 404. In some cases, community banks have had to contract with third-party vendors to complete this work. One community bank with $140 million in assets noted that its biggest problem is finding the manpower with expertise to do the job. As this bank noted, the amount of work required to comply with Section 404 is the same for it as it is for a bank ten times its size.

This lack of adequate manpower can be attributed to the fact that small banks often compete with audit firms and larger companies that can offer greater benefits to hire the same people. Some small businesses must hire "vendors", which are very costly both in terms of financial resources and training to learn the small company's particular processes and work flow. For small businesses in small communities, the experienced vendors are generally not local, leading to additional large out-of-pocket reimbursements.

Banks of all sizes are pleased with the new guidance PCAOB issued on May 16, 2005. Although that guidance addressed many concerns and promises to simplify somewhat the work required of both large and small companies, the jury is still out as to whether it will, in fact, reduce costs. Believing that further changes are still crucial for small businesses, the ABA offers the following additional recommendations for reform:

Recommendation 1 – Require Attestations Rather Than Both Attestations and Audits

As we have previously advocated, the ABA suggests that the Commission simply require attestations rather than both attestations and audit opinions on internal controls.[13] For the purpose of reporting on internal controls by management and the related attestations by auditors, the requirements of FDICIA

[13] See Letter of April 1, 2005, from Donna Fisher, ABA, to Jonathan G. Katz, Securities and Exchange Commission.

and the Sarbanes-Oxley Act are virtually identical, both requiring attestations rather than audit opinions. Similarly, the regulations that implement those laws[14] are the same, with the exception of the definition of the reporting entity, the requirements relating to material weaknesses, and certain quarterly procedures.

Unfortunately, the similarities between FDICIA and Section 404 implementation diverge under the rules issued by the PCAOB. When the PCAOB developed its new auditing standard, Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" ("AS 2"), to help auditors provide the Section 404 attestations, it expanded the Section 404 requirement from an attestation by external auditors on management's assessment of internal controls to include an additional stand-alone opinion by external auditors on internal controls.

The PCAOB appears to have based its decision to require audits[15] on Section 103(a) of the Act. The ABA does not believe that Section 103(a), which describes the rules the PCAOB must establish, requires audits. Instead, Section 404 clearly states that attestations[16]—not audits of internal controls—are required in the reporting process.

The requirement for attestations in addition to audits of internal controls has led auditors to re-test management's testing of internal controls and then perform new tests of those same areas for the audits of internal controls. For small banks especially, this unnecessary duplication of effort is costly and provides little corresponding benefit. We believe that these redundant tests are unnecessary.

Recommendation 2 – Eliminate Testing by Management

The segregation of duties in major risk areas of a small company is possible. However, segregating the duties of performing a control, checking the control, and testing the control is extremely difficult for small businesses with few employees. Often, small companies must hire an expensive independent firm to perform the Section 404 testing – in some cases, a waste of shareholders' investment in the business.

The ABA encourages the Committee to examine the lack of employee resources by evaluating the necessity for management to perform independent testing. For example, investors in small banks may find it acceptable to know that management has controls in place that are documented. Management could report on internal controls, based on the documentation it receives from the company's various business areas, and auditors could attest to management's assertions. The documentation would also be the basis for the auditors' testing and reporting.

[14] FDIC 12 CFR Part 363; SEC Release No. 33-2838.

[15] PCAOB, Auditing Standard No. 2, ¶¶ E15-E16.

[16] AS 2 states that: "An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion."

If the Committee does not adopt this recommendation, as an alternative, we suggest that the Committee recommend that the Commission clarify the scope of testing for small companies. Without such clarification, the coverage may be in practice inconsistently applied and extremely high for many small businesses.

Recommendation 3 – Allow Testing at Various Times During the Year

The ABA also recommends that the Commission consider a 90-day window, prior to a company's fiscal year-end, during which a company could establish its "as of" assessment date. Closing procedures are generally the same for third and fourth quarter, and this regulatory relief could ease some of the staff work overload at year-end for both the accounting firms and banks.

Many small businesses have great difficulty completing the work at year-end while continuing to focus on business needs. Again, this issue concerns manpower, and either the above recommendation or a variation of it could reduce the strain on small companies. For example, some small businesses would like to perform testing earlier in the year, but additional work looms at year-end. In some cases, small businesses over-test because they are uncertain as to how much to do initially as well as during re-performance of the testing. For example, could the entity perform certain tests during a specific quarter, as long as such testing is performed during the same quarter each year, and not prepare a rollforward of testing? If so, could the auditors also attest to those specific tests as of management's testing date and disclose the timing in its attestation? This flexibility would be extremely useful to companies, which are busy at year-end, as well as to audit firms, which are often thinly staffed at year-end.

The ABA recognizes that the law specifies the "as of" date. However, the Commission could require that companies use a consistent "as of" date (along with very limited rollforward procedures at year-end relating to significant changes) to ensure compliance with the law.

Recommendation 4 – Require Reporting Less Often Than Annually

The banking industry is highly regulated from a risk perspective, which mitigates the need for annual assessments of internal controls. The Commission should require these assessments every other year with the focus on activities surrounding the core business or high risk areas and on frequency and severity of material losses or misstatements.

Recommendation 5 – Improve the Relationship Between Management and Auditors

The role of external auditors needs to return to a trusted – albeit arms-length – advisor role. Although the Act clearly increases the tension between an auditor's role as both an advisor and independent examiner, it appears that the division may in practice have shifted too far. The ABA believes there are at least two reasons for this: (1) the new reporting relationship between the auditor and the audit committee; and (2) the rules relating to auditor independence. In the past, auditors provided management with helpful recommendations for improvements. However, in the current environment, this relationship has shifted heavily toward enforcement, with the almost complete loss of the auditor as a valued advisor to management. Often smaller institutions are particularly affected by this situation because they do not have a wide range of outside advisors on retainer.

The PCAOB's May 16, 2005, guidance addresses part of this concern by clarifying that audit firms can participate in draft financials and discussions about the appropriate accounting. However, there is room for further improvement. For example, external auditors should evaluate the frequency of contact with audit committees, consider whether the issues presented to the audit committees are significant enough to require the audit committee's attention and whether the issues raised are a wise use of the audit committee's time. The appropriate level of audit committee involvement is important so that there is no blurring of the distinction between the responsibilities of the audit committee and fundamental management responsibilities and also so that the audit committee can address those issues that matter most.

Recommendation 6 – Carefully Review Accounting Standards for their Effect on Small Businesses Prior to Issuance

The Committee has raised some difficult questions on accounting standards. Most community banks would probably respond that the current accounting standards are in many ways inappropriate for smaller companies. However, many would also prefer not to learn two different sets of standards to evaluate borrowers' financial statements.

The best example of an overly complex standard for small companies is accounting for derivatives, Statement of Financial Accounting Standards No. 133.[17] This standard and the many Derivatives Implementation Group decisions fill pages and pages, making it virtually impossible for a small company to digest all those rules. Some have argued that small businesses should not be involved in derivatives, which may be true for some businesses but certainly not for an industry such as banking that daily faces interest-rate, credit, and currency-exchange risks.

An example of an unnecessary accounting standard for small banks is fair value disclosures.[18] Analysts do not even question the largest banks about such disclosures, making it difficult to believe that full compliance with SFAS 107 is necessary for small companies – especially because so many of the values lack sufficient reliability, simply due to the nature of the financial instrument.

In addition to the application of some of the standards for small banks, there are problems relating to the frequency of change in accounting standards for financial institutions. The Financial Accounting Standards Board ("FASB") continues to develop many new rules and new interpretations of existing rules relating to financial instruments, resulting in many changes for small financial institutions. Many of the proposals or final rules either have the potential to or

[17] SFAS No. 133, Accounting For Derivative Instruments and Hedging Activities.

[18] Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments.

actually do result in major changes for small banks, resulting in costly new procedures. Often, the costs of implementation outweigh the benefits for small banks.

As part of the Commission's oversight of the FASB, the ABA encourages the Commission to work with the FASB to prioritize the new accounting changes needed and evaluate the costs and benefits for both large and small companies. We have worked with the accounting standard setters on small bank concerns. We appreciate the many changes the Commission has made to proposed rules as a result of those efforts. However, further evaluation of costs versus benefits are needed, including not only the consideration of dollar costs, but also time costs.

Extended effective dates for accounting standards sometime provide small businesses with the opportunity to learn from the experiences of larger companies. Similarly, the smaller audit firms that work with small businesses have the opportunity to learn from the experiences of larger audit firms. Extensions also provide smaller companies with a longer time frame in which to employ their scarce resources for implementation. Although this is beneficial, it should not be viewed as a substitute for evaluating the costs versus benefits of proposed rules. Because financial institutions have experienced many significant changes in accounting standards, we believe that auditors' assistance with accounting and reporting may be necessary for many small institutions. This situation is true not only for unusual or infrequent transactions, but also for common transactions for which the accounting has been in existence for years. Small businesses cannot read the minds of audit firms and others as new interpretations of old rules unexpectedly arise. Some small businesses find it virtually impossible to keep up with both the formal and informal changes to accounting for financial instruments. Therefore, the interests of investors are best served if small businesses are permitted access to their audit firms' expertise.

Recommendation 7 – Establish a Resource Center for Small Business Questions

Some of the problems reported to us by our members for 2004 Section 404 reporting may seem fairly minor from a large company perspective, but they are not for smaller companies. Often, the small companies must rely on information on these matters from their accounting firms, which may or may not be correct.

Some small banks informed us of disagreements with external auditors over whether certain controls were in place and were working. Often they would disagree on whether certain controls existed and whether mitigating controls were sufficient. A small company has no ability to second guess the final decision of the external auditor in these situations. One might argue whether it is appropriate to second guess a particular decision; however, the point is that it is a very frustrating process for a small company.

Small companies are also finding it difficult to determine how much work and testing are required in connection with quarterly certifications. For a larger company that has a deep accounting bench, the company can make this decision on its own. However, for small companies, this decision is more difficult and can result in wasted time being spent on quarterly certifications.

Although the ABA does not have a specific proposal to address this concern, the Commission should consider providing technical guidance or establishing a technical resource center available to smaller companies.

Corporate Governance/Listing Requirements

Many publicly-traded community banks are not listed on any exchange and, thus, are not required to comply with the various exchanges' listing requirements. Nevertheless, community banks are still significantly affected by these listing requirements due to the Commission's requirement that companies not listed on an exchange disclose in their proxy statements whether or not audit and nominating committee directors are independent.[19] In addition, the community bank's proxy disclosure must make clear which exchange's director independence definition it is employing. Consequently, the various exchanges listing standards regarding director independence are very important to our members.

Banks are in the business of providing credit and other services, often to customers that often include board members and their companies. It is very common for directors to obtain home mortgage loans, credit cards, checking and savings accounts, or personal and company lines of credit through the same bank or savings institution on whose board they sit. If these services when offered at an arm's length basis to a director's company were to render that director "not independent", our members would either lose valuable and legitimate business or would significantly reduce the number of qualified business leaders available to sit on banking organizations' boards. These concerns are especially true for community banks, which typically have a narrower geographic presence and thus have access to a smaller pool of potential candidates.

Both the New York Stock Exchange ("NYSE") and the NASDAQ have recognized the unique nature of banks and have provided that certain ordinary course of business transactions with both directors and their affiliated companies will not impair a director's independence. It would be helpful, however, if the NYSE were to amend its Listed Company Manual Section 303A to recognize that loans, including interest payments and other related fees paid on extensions of credit, to director-affiliated companies that are in accordance with the non-preferential lending requirements set out in the Federal Reserve Board's Regulation O will not impair a director's independence.

Section 303A.02(b)(v) defines "independence" to exclude "a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such company's consolidated gross revenues." In 2004, the NYSE clarified that loans from financial institutions to listed

19 See e.g., Item 7 to Schedule 14A, 17 CFR 240.14a-101.

companies would not be considered "payments" for purposes of Section 303A.02 but that the interest payments or other fees paid in association with such loans would be.

While we are very appreciative of the NYSE's efforts to recognize the unique nature of banks, this interpretation requires those community banks that follow the NYSE director independence standard to incur significant compliance burdens. Specifically, once a bank identifies and catalogs loans made to affiliate companies of directors, it must then separate principal and interest payments for that year and add any associated fees to the interest payment received to calculate whether monies received from a director's company or family member's company comes within the 2%/$1 million limitation. It would be much simpler if banks, especially those with fewer resources, did not have to perform this analysis with respect to any loans that they knew were permissible under the Federal Reserve's Regulation O.

Regulation O requires that extensions of credit made to companies that are related interests of a director must be made on substantially the same terms and conditions as comparable extensions of credit to comparable borrowers. We would submit that because Regulation O achieves the same purpose as the listing standards, namely ensuring that director independence is not impaired, no need exists to apply Section 303A.02 against loans that are in compliance with Regulation O.

Both the Congress and the NASDAQ have recognized the importance of Regulation O. Specifically, the NASDAQ recognizes that loans permitted under Section 13(k) of the Exchange Act will not impair a director's independence. Section 13(k) was added to the Exchange Act by Section 402 of the Sarbanes-Oxley Act. That section generally prohibits publicly-held companies from making personal loans to any director or executive officer of the company. This prohibition does not apply, however, to loans made by an insured depository institution, if the loan is subject to the insider lending restrictions of Regulation O.

In this connection, the Committee has asked whether Section 402 is creating hardships for smaller public companies. While, as noted above, loans made in accordance with Regulation O are exempt from the prohibition, there is still much confusion as to what constitutes "a personal loan." For example, many banks are unsure as to whether a split-dollar life insurance plan would be considered a "personal loan" under Section 402. These life insurance arrangements are often an important part of an executive officer's compensation package. Numerous other questions abound regarding the definition of "personal loan."

Unlike large public companies, smaller companies, including banks, often do not have the extensive legal resources necessary to interpret all the ambiguous statutory and regulatory language that affects them. SEC guidance regarding the limits of Section 402 and the definition of "personal loan", as well as what activities constitute "arranging" for an extension of credit, would be most welcome and might alleviate some of the legal expenses of smaller institutions.

Disclosure System

Electronic Delivery of Proxy Statements

In implementing the small business initiatives in the early 1990s, the Commission recognized that the federal securities laws and their disclosure requirements create very significant costs for start-up and small business companies seeking to raise capital. Despite the regulatory relief of those initiatives, smaller institutions are still concerned about the disclosure requirements and the costs of compliance. As a case in point, the costs of preparing and distributing printed paper versions of proxy statements and annual reports to shareholders are indeed more burdensome to smaller companies. Without the advantage of large economies of scale, printing and distribution is far more expensive per unit for smaller banks. Implementing an optional electronic delivery system would greatly benefit those institutions that have the requisite systems capabilities.

Regulation S-B

Regulation S-B provides that companies that meet the definition of "small business issuer" are permitted to use Form SB-2 for registration of their securities under the Securities Act of 1933 and Forms 10-KSB and 10-QSB for their annual and quarterly reports under the Exchange Act. These forms are somewhat abbreviated versions of Forms 10-K and 10-Q.

One of the criteria for using these abbreviated forms is that the "small business issuer" must have revenues of less than $25 million or a public float (the aggregate market value of the issuer's outstanding voting and non-voting common equity held by non-affiliates) of $25 million or more. While Regulation S-B does provide meaningful relief for a small number of banks, it should be available to a much larger group of community banks. In 2004, only 197 federally-chartered banks and 101 state-chartered banks were able to file a 10-KSB under Regulation S-B.[20] These community banks represent less than three and a half percent of the total number of FDIC-insured depository institutions.[21]

Over the years, these simplified disclosure requirements have become less effective in moderating the filing burdens of community banks than when they were first issued in 1992. As with the 500 shareholder threshold limit under Section 12(g), it is now appropriate to revise these numbers upward.

Alternatively, the Commission can adopt an alternative definition of "small business issuer" under Regulation S-B. Specifically, the ABA suggests that the Commission define small business issuer by referencing asset size. The bank regulators define a small bank for purposes of the Community Reinvestment Act as $1 billion in assets.[22] Finally, the Commission could use the number of employees as

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20 Search of EDGAR Database, SEC (Aug. 30, 2005) (search for records containing "10KSB" and SIC numbers: "6021", "6022", "6035, and "6036").

21 Search of FDIC Institution Directory (Aug. 30, 2005) (search for all FDIC-insured institutions).

22 See e.g. 12 C.F.R. §228.12 (u).

the criterion for small business status. The SBA has defined small, medium and large businesses by reference to the number of full-time employees, e.g., small firms (less than 20 employees), medium (20-499 employees), and large (500 or more employees).[24] Sixty-three percent of the industry's 5,600 banks and savings associations have 50 or fewer employees. The average asset size for this group is approximately $100 million.

Conclusion

The ABA appreciates the opportunity to comment on the effect of the Sarbanes-Oxley Act of 2002 on small banks. These comments are in addition to those we previously provided to the Commission on issues affecting community banks.[25] Corporate governance and the regulatory framework in general have become an increasingly important issue for our member banks, both large and small. However, given their more limited resources, the community banks have proportionally experienced the heaviest burden from the requirements. We hope that our comments will assist the efforts of the Committee in drafting its recommendations for the Commission's consideration. Please do not hesitate to contact the undersigned should you wish to discuss these matters further.

Sincerely yours,

Sarah A. Miller

24 W. Mark Crain and Thomas D. Hopkins, The Impact of Regulatory Costs on Small Firms, Report for the Office of Advocacy, U.S. Small Business Admin., RFP No. SBAHQ_00-R-0027.

25 American Bankers Association, supra note 10.