America's Community Bankers Shaping Our Future

August 9, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

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

Dear Mr. Katz and Advisory Committee Members:

America's Community Bankers ("ACB")[1] would like to take this opportunity to comment on the work of the Advisory Committee on Smaller Public Companies and provide some suggestions to relieve the burden of the federal securities laws on smaller companies. ACB is the national trade association for over 1,200 community banks across the nation. Our membership is made up of national and state commercial banks as well as federal and state savings associations. Our members are public, private and mutual associations.

Complying with the federal securities laws has always been more difficult for the smaller public companies because of their more limited resources. In deciding to access the public equity markets, companies must weigh the costs and benefits of being a registered public company and having shares listed on a national exchange. That cost/benefit analysis has become even more important in light of the passage of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), the issuance of new corporate governance listing standards by the national security exchanges, and the more aggressive enforcement activities of regulators. It would be a shame if all of these new demands and risks dissuaded smaller companies from becoming public or remaining public if there were alternatives available that relieved the burden of laws and regulations while continuing to protect investors. Smaller companies are the primary catalyst for job creation and are an essential component for having a strong and dynamic market economy. These companies need flexibility in determining where to find funding to grow their businesses. Sometimes access to the public markets makes the most sense.

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[1] America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit *www.AmericasCommunityBankers.com.*

Public community banks are particularly stressed by many of the new securities laws changes. Those banks already are subject to a great deal of regulation and are subject to periodic safety and soundness examinations by federal bank regulators. Some of the corporate governance changes, brought on by egregious accounting and governance scandals at larger companies, tax these companies even further to the point that it becomes unreasonable to remain public. In addition, small private banks and mutual organizations are feeling the effects of some of the changes as there is pressure to comply with what are deemed to be "best practices" and public auditors are subjecting all depository institutions required to produce internal control reports to the public company attestation standards.

We are using this opportunity to provide some suggestions for change to relieve the burden on smaller companies while still protecting investors. We start with a general discussion of what we believe constitutes a "smaller public company" that should benefit from burden relief. The remaining suggestions are arranged based on the subject matter focus of each Subcommittee of the Advisory Committee.

Definition of Smaller Public Company

Currently, there are several size categories under the federal securities laws, with two critical ones on which we wish to comment being the $75 million threshold for accelerated filers and the $25 million threshold for "small business issuer" status.

We agree with other commenters that the accelerated filer threshold should be increased to $700 million. The SEC's own research indicated that the $700 million threshold was the level at which a company becomes widely followed and these larger companies represented about 95 percent of equity market capitalization. There is a great deal of difference between a $75 million company and a $700 million company in terms of staff and financial resources to meet more rigorous standards. Smaller companies were required to comply with section 404 of Sarbanes-Oxley on the same time frame as the much larger companies, even though they did not have the internal resources to comply and had difficulty getting the attention of outside experts and auditors. The SEC already has used the accelerated filer category to differentiate among companies with regard to certain filing requirements. We believe the SEC should use the non-accelerated filer status, as adjusted to the higher $700 million threshold, to identify companies that should receive more lenient regulatory treatment in the future as smaller public companies.

We also believe that "accelerated filer" status should not be measured as of a single point in time. This makes it too difficult for smaller companies who suddenly find themselves over the threshold based on what may be a temporary increase in stock price. We would recommend that the status be determined by looking at average market capitalization over an extended period of time.

The $25 million threshold for "small business issuer" has not been changed since 1992, even though the average size of companies has increased significantly over this period. In order to make this status more meaningful, we suggest that the threshold be raised to at least $100 million of revenue and public float.

Internal Control over Financial Reporting

Section 404 of Sarbanes-Oxley is the most burdensome new requirement in the legislation. It is not so much the language of the law that creates the problems, but the way it has been implemented under the rules and regulations of the SEC and the Public Company Accounting Oversight Board ("PCAOB"). We are hopeful that the guidance issued on May 16, 2005 by each of those agencies will make a difference before smaller companies must comply beginning in July, 2006. However, we are not counting on that to happen. As long as the auditors must provide their own opinion on the effectiveness of internal controls, rather than attest to management's assessment, we fear that the auditors will not change their approach significantly. Anecdotal evidence to date, including conversations our public members have had with their auditors, show that the guidance has not yet had any effect on the way the auditors are approaching this work.

Much has been written about the burden of section 404 and we will not repeat the complaints here. We have attached our letter to the SEC in connection with its section 404 roundtable in April that summarizes the concerns of our members with regard to section 404's expense and burden.

We have the following suggestions for reducing the burden of section 404 on smaller community banks.

- The effective date for non-accelerated filers should be delayed for another year so that compliance would be required for fiscal years beginning after July 15, 2007. This is justified for many reasons. It will take some time for the guidance issued May 16 to be digested by the auditors and for the regulators to see if the guidance makes a difference in approach. Also, the Committee of Sponsoring Organizations of the Treadway Commission ('COSO") has delayed the release of an exposure draft on *Implementing the COSO Control Framework in Smaller Businesses* until August, at the earliest. Once released, it will take time to accept comments and issue final guidance. Finally, the PCAOB has said that it will use the inspection process to examine auditor's application of Auditing Standard 2 and will address instances where the auditors have taken an unreasonable approach. This process will take a year or two before it has any effect on unnecessarily burdensome practices. It would be very unfair to expose smaller companies to the significant burden and expense of section 404 until all of the implementation issues that arose with the larger companies are resolved.

- We think that all banks and savings associations that are so heavily regulated and subject to regular safety and soundness examinations should be exempt from the section 404 requirement. It is difficult to see why companies that operate under a microscope should be subject to the same burdensome requirements as companies that are not regulated at all.

- Understanding the difficulty in implementing an overall exemption for banks and savings associations, we believe that community banks and savings associations with less than $1 billion in assets should be exempt from section 404. The legislative language in section 404 mirrored that found in requirements imposed by the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"). FDICIA required that banks and savings associations provide an annual management report on internal controls and obtain an attestation of management's assessment by the external auditor. (We note here that the bank regulators never required a separate opinion from the auditor.) Recognizing the significant burden this requirement would place on smaller institutions, and knowing that those smaller institutions were subject to extensive examination, institutions with less than $500 million were excluded from that requirement. The bank regulators recently proposed an increase in the exemption threshold to $1 billion. If the banking agencies believe that $1 billion institutions can be exempt from the requirement without harm to the industry, it seems that an exemption under section 404 also could be granted without harm to investors. Investors would otherwise be protected by the complete application of all other regulatory requirements and periodic safety and soundness examinations.

- We believe that the following suggestions for changes in the approach of section 404 audits would help relieve the burden of the requirements for smaller companies:

  Relax the requirement so that the report and audit is required every two or three years.

  Issue guidance that *requires* staggered testing of controls, with more important controls tested more frequently.

  Issue guidance that *requires* external auditors to rely on the work of management and internal audit unless there is reason to believe that the work is flawed.

  Adopt a definition of materiality for smaller companies that takes into account the smaller level of revenues and profits. For example, materiality could be measured after removing the effects of stock option expensing and on an annual, rather than quarterly basis. Otherwise, almost any potential problem becomes material for a smaller company, leading to an unnecessary amount of documentation and testing.

Corporate Governance and Disclosure

<u>Filing Deadlines</u>. Over the course of the last few years after passage of Sarbanes-Oxley, the SEC has accelerated the filing deadlines for periodic reports on Forms 10-Q and 10-K, current reports on Form 8-K, and insider beneficial ownership reports under section 16. Unlike larger

companies, smaller public community banks do not have employees on staff dedicated to filing these reports so either have to divert attention from other matters to meet stringent deadlines or hire outside help. The two business day deadline for section 16 reports is particularly difficult because these reports are required from principal shareholders, directors and executive officers, and a certain amount of coordination with these parties must be arranged. Also, in light of the significant number of items that now must be reported on Form 8-K, the new four-business day filing requirement takes its toll on staff. Smaller companies do not have the staff resources to handle the increasing amount of information that has to be filed. Shareholders in these smaller companies do not need or want so much information on such an immediate basis. Also, shorter deadlines only encourage those investors who already have a short-term outlook on investments when it seems prudent to encourage longer-term investment objectives.

We suggest that the deadlines for non-accelerated filers be changed to 10 calendar days for filing current reports on Form 8-K and section 16 beneficial ownership reports.

When the SEC accelerated the deadlines for periodic reports, it provided an exemption from the new deadlines for non-accelerated filers. However, larger companies are also now experiencing problems with the deadlines in light of the substantial work that must be done to comply with Sarbanes-Oxley. Therefore, the SEC should consider freezing the current deadlines that are now in place rather than phasing in the final step in the acceleration schedule that would require annual reports be filed within 60 days and interim reports be filed within 35 days.

<u>Definition of Independent Director</u>. ACB urges the SEC and the national stock exchanges to relax the definition of independence for purposes of board and audit committee service for non-accelerated filers. Community banks undertake substantial efforts to find qualified directors willing to serve on the board and its various committees. Bank directors not only have responsibilities under applicable corporate and securities laws, but they also must understand and enforce a full range of banking laws and regulations. Especially after passage of Sarbanes-Oxley, many qualified individuals cannot put in the necessary time and effort that is now required for board service and some also are wary of the increased exposure to personal liability. Because a community bank generally seeks to elect directors from the bank's community, this further narrows the field of potential candidates.

Changes in the definition could broaden the pool of candidates without interfering with the goal of Sarbanes-Oxley to install board members who can competently perform their oversight role and exercise independent judgment. We urge that the following changes be made to the definition of independence:

- There currently is no *de minimis* exception to the prohibition on the receipt of any direct or indirect consulting, advisory, or compensatory payments by audit committee members. The current rule creates challenges when seeking qualified audit committee members when you couple the prohibition with the look-back provisions of the stock exchange listing requirements and the fact that the prohibition extends to family members. We also note that the Federal Deposit Insurance Corporation ("FDIC") recently proposed relaxing the audit committee independence rules for insured depository institutions of less than $1 billion in assets in recognition of the increasing difficulty of finding qualified audit committee members. The only requirement under the FDIC proposal is that audit committee members not be officers or employees of the institution or any affiliate at the time of service or within the preceding year.

We think this approach is appropriate for depository institutions because board and audit committee oversight is examined on a regular basis by the federal bank regulators. If this is too far for the Advisory Committee to go in its recommendations, we believe there should at least be a *de minimis* exception to the prohibition on compensatory payments. For example, the New York Stock Exchange rules allow payments to independent directors, but not audit committee members, of up to $100,000. Under the original proposal, but not in the final rules, payments over $100,000 would have only established a rebuttable presumption that the individual was not independent. We believe this is a reasonable approach for all directors, including audit committee members, of smaller public companies. Even with an exception, the rules could require that the board of director be notified of any payments made to a potential director candidate and make a determination as to whether the payments would affect the ability of the director candidate to act independently.

- The stock exchanges should be encouraged to define an independent director for smaller public companies as an individual who is not employed by the company or an affiliate, and who does not have a spouse or children employed as an executive officer of the company or an affiliate, and who does not have, in the opinion of the board, any relationship that would interfere with the exercise of independent judgment. This would be a reasonable and practical approach.

  A less far-reaching alternative would be for the stock exchanges to at least narrow the look-back provisions and the definition of immediate family members to broaden the pool of independent director candidates for non-accelerated filers. Those rules can work fine for Fortune 500 companies that can look nationally for board candidates. For the smaller geographical area that provides candidates for the smaller companies, however, the rules unnecessarily narrow the pool of potential directors. Smaller companies should have the ability to cease any payments and terminate any business relationships with an individual that would otherwise preclude him or her from being considered independent and family member should only include spouse and children.

Auditor Independence. The independence rules should be relaxed so that auditors can provide advice to companies with regard to the proper application of accounting rules and Auditing Standard No. 2. The implementation of section 404 and Auditing Standard 2 has exposed a problem with the tough auditor independence rules resulting from Sarbanes-Oxley. Auditors have taken a very stringent position and will no longer provide any advice or help at all with regard to the application of very complex accounting rules. Smaller companies do not always have the internal staff expertise to work through complex requirements and it is expensive to seek outside help. In the past, management could work cooperatively with auditors to ensure an approach that everyone could agree was the correct one. With the continuing complexity of accounting rules, appropriate changes to the auditor independence requirements should be made for smaller companies to allow this level of cooperation to continue.

Disclosure Rules. Serious consideration should be given to whether smaller public companies should have less extensive disclosure requirements. The amount of detail in current disclosures is more than is needed by investors. Also, investors in depository institutions have access to extensive quarterly financial reports that are filed with the federal banking regulators. These reports are filed within 30 days of the end of each quarter and are available to the public soon thereafter.

Capital Formation

Registration Requirements. The threshold number of shareholders that requires registration with the SEC needs to be modernized to reflect changes in corporate structure over the last 65 years. Current requirements set the threshold at 500 shareholders of record for registration and 300 for withdrawal from registration. These standards have been in effect since 1964 and do not reflect the significant growth in companies since that time. We suggest a threshold that is effective in requiring disclosure and protection in those instances where a company is of a substantial size and has a significant investor following. We urge consideration of two different recommended thresholds: one based on "shareholders of record" and one based on "beneficial shareholders." A public float threshold in combination with number of shareholders may be appropriate. At a minimum, however, we believe that the threshold for registration should require at least 1,250 beneficial shareholders, with an appropriate corresponding threshold for withdrawals that is not less than 1,000 beneficial shareholders.

Accounting Standards

While we do not support different accounting standards for small companies, something needs to be done about the complexity of accounting rules and principles. It is increasingly difficult for smaller companies to understand and apply accounting standards without external help. A perfect example is the new stock option expensing rules. Rather than try to understand and apply the new rules or hire expertise, smaller companies will choose to terminate stock option plans. Accounting standards should be written in a way that is clear and understandable and should be relatively easy to apply. To the extent possible, they also should not lend themselves to disagreement on outcome based on who is doing the analysis. We do support longer transition periods for smaller companies so that they have the necessary time to review and understand new accounting rules.

ACB appreciates the opportunity to provide these comments to the Advisory Committee. If you have any questions, please contact the undersigned at (202) 857-3121 or via e-mail at cbahin@acbankers.org, or Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org.

Sincerely,

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