

Congress of the United States

House of Representatives

109th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6315

February 16, 2006

Chairman Christopher Cox
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

We are writing you regarding the effect of the Sarbanes-Oxley Act (P.L. 107-204, "the Act") on small companies and to urge the Securities and Exchange Commission ("SEC" or "the Commission") to take action pertaining to this matter within the next year. We recognize and applaud the Commission's establishment of the Advisory Committee on Smaller Public Companies and believe that the Advisory Committee's efforts to date are building a foundation for real and meaningful action on this issue.

In Fall 2005, the Democratic Members of the House Small Business Committee held a roundtable on the effect of the Act on small companies. During this roundtable, Democratic Members met with leaders from the nation's business community and discussed their concerns about the Act's impact on small firms, as well as its effect on the United States economy more generally.

We found that small businesses support the aims of the Act, recognizing the importance of strong corporate governance practices and shareholder accountability. Small firms agree that companies have a legal and moral obligation to provide shareholders, employees, and the public with information that is accurate and transparent. However, for many small companies – both public and private – compliance with Section 404 of the Sarbanes-Oxley Act in its current form is jeopardizing their economic viability.

The roundtable resulted in several findings related to the Act's affect on small companies. These findings, as well as recommendations to the Commission, are discussed in detail below.

Findings

The most frequently voiced concern of roundtable participants pertained to the cost of documenting and assessing internal controls as required by Section 404 of the Act. During the roundtable discussion, participants noted that the expenses associated with Section 404 are substantial and can exceed \$400,000 annually for small firms. In particular, participants cited the expenditures associated with hiring financial professionals and outside auditors as the main driver of their Section 404 outlays.

Small companies, despite having fewer employees, less access to capital, and simpler operating structures, must establish the same type of internal control systems as their larger counterparts. Due to the significant fixed costs associated with instituting these new systems, small businesses are spending a greater portion of their available financial resources on these compliance activities. Many participants suggested that the concentration of the requisite expertise in so few accounting firms has contributed to the considerable expenses associated with Section 404 compliance.

For many companies, these additional outlays are significant. Participants stated that the magnitude of these expenditures has caused small companies to forgo growth opportunities, constrained their financing options, and diverted funds from research and development. Most troubling is the potential for compliance activities to crowd out research and development in smaller companies, which serves as the foundation for future economic and job growth.

Participants noted that the increased cost of regulatory compliance is causing some small firms to trim their research budgets by employing foreign engineers and researchers, something they had never considered pre-Sarbanes-Oxley. Participants expressed concern that on-going compliance expenditures will not decrease as much as was expected, raising further fears that Section 404 will have a long-term financial impact on small firms' competitiveness.

Further concerns were expressed that senior officers are spending too much time on Section 404 compliance requirements and too little time on core management activities. For small firms, where "senior management" may only include two or three individuals, this shifting of executive focus can have serious negative implications for companies' future success, particular those that are less mature.

For financial institutions, particularly smaller community banks, compliance with Section 404 has created substantial challenges. Raising capital to launch a new bank is difficult in itself, but with the new costs of Section 404, such tasks are increasingly cost prohibitive. By impeding capital formations for these highly regulated financial institutions, many communities may lose their only lenders, making it harder for small businesses and homeowners to access the affordable capital they need.

The burden associated with Section 404 of Sarbanes-Oxley is creating additional barriers for small companies – both public and private – to access the capital markets. This could compel many smaller public companies to delist from SEC registered exchanges and either go private or trade on the less regulated over-the-counter market. In many regards, this outcome makes it more difficult for small firms to raise capital, potentially limiting the economic growth of these companies.

For many private companies, compliance with Sarbanes-Oxley is no longer a choice, as many of these firms must adhere to the Act's requirements if they are to preserve their ability to go public or to be able to merge with a public company. In addition, venture capital-backed companies are being forced to expend scarce resources earlier in the process in order to maintain the future ability of their portfolio companies to go public or to be acquired. Not only does this resource allocation adversely impact innovation and economic growth, but it is also causing smaller firms to reconsider whether the benefits of going public, merging with a public company, or securing venture capital is worth the attendant costs.

Recommendations

The roundtable participants provided great insight into the challenges small companies face in complying with Section 404 of the Sarbanes-Oxley Act. While it is clear from the above findings that the Act places a disproportionate amount of strain on small companies, it is of equally great concern that the Act will have a unfavorable effect on the degree of innovation and entrepreneurship in the American economy.

In order to address these concerns, we ask that the Commission recognize the unique circumstances that small businesses face in fulfilling the responsibilities of the Sarbanes-Oxley Act, particularly those required under Section 404, and to establish standards that permit small businesses to meet these responsibilities without undue burden. By doing so, we believe that the Commission can better balance its investor protection mandate with the need to ensure small firms' continued access to the capital markets.

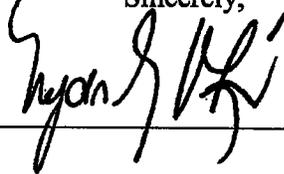
The Commission has a long tradition of recognizing the uniqueness of small businesses, and thus granting them size specific regulations. Such instances include small business exemptions from certain registration requirements under the Securities Act of 1933 ("the Securities Act") and the establishment of disclosure requirements for small business issuers under the Securities Act and the Securities Exchange Act of 1934. In doing so, the Commission has provided small firms with a less burdensome path to the public capital markets, while ensuring that investors and shareholders are protected.

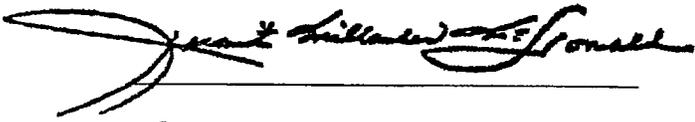
Similarly, we ask the Commission to recognize this unique dynamic in its application of Section 404 of the Sarbanes-Oxley Act. Choosing to adopt more flexible compliance standards for small businesses will not undermine investor protection or jeopardize the corporate governance goals of the Act. Instead, such standards will ensure that publicly traded small businesses can serve shareholders to the best of their ability, allowing them to provide enhanced transparency, but without the substantial expense that is causing many smaller companies to sacrifice future growth.

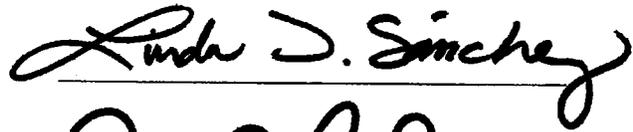
We also ask the Commission to develop approaches that would broaden small firms' access to the professional services required under the Sarbanes-Oxley Act. By increasing the availability of such expertise, the Commission can ensure that all companies, irrespective of their size, can readily and affordably comply with the Act's requirements.

Reducing the unnecessary burden that Section 404 of the Sarbanes-Oxley Act imposes on small firms not only will benefit the companies themselves, but also the economy more broadly. Entrepreneurial activity has always been the foundation of the U.S. economy and by taking prudent steps to encourage rather than stifle innovation, we can help preserve and even enhance the competitiveness of American industry. We recognize your hard work and commitment on these issues and thank you for your attention to these matters of importance to small businesses and the economy.

Sincerely,

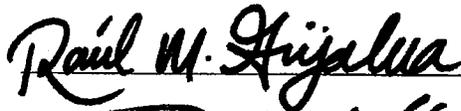




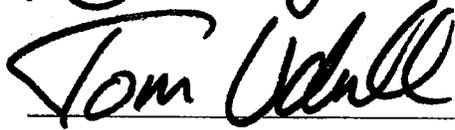


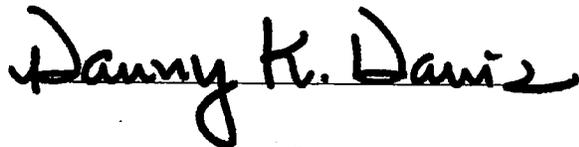




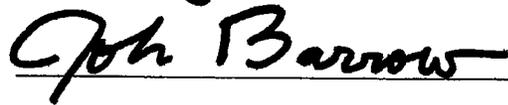


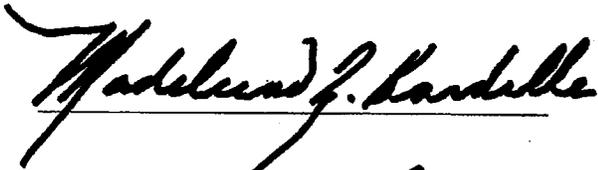






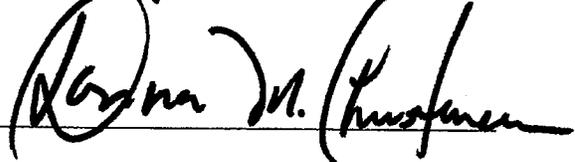












cc: The Honorable Paul Atkins, Commissioner
The Honorable Roel Campos, Commissioner
The Honorable Cynthia Glassman, Commissioner
The Honorable Annette Nazareth, Commissioner
Herbert S. Wander, Co-Chair, Advisory Committee on Smaller Public Companies
James C. Thyen, Co-Chair, Advisory Committee on Smaller Public Companies