



**SEMI North America**  
1401 K Street, N.W., Suite 601  
Washington DC 20005

Tel: 1.202.289.0440  
Fax: 1.202.289.0441  
semidc@semi.org  
www.semi.org

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VIA E-Mail

Ms. Nancy M. Morris  
Federal Advisory Committee Management Officer  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090  
*rule-comments@sec.gov*

Re: File No. 265-23, Exposure Draft of Final Report of Advisory Committee on  
Smaller Public Companies (Release No. 33-8666; 34-54385).

Dear Ms. Morris:

Semiconductor Equipment and Materials International (SEMI) appreciates the opportunity to comment on the Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies ("the Draft" or "the ED"). We commend the fine work of the Committee in developing these many thoughtful recommendations and this thorough Exposure Draft. We believe that the main recommendations in the ED strike the appropriate balance between cost and benefit for smaller public companies and their shareholders.

Therefore, our specific comments attempt to assist the Committee in refining the Draft so that the final Committee Report can bring about actual changes that will improve the overall climate for smaller public companies. We recognize that the Committee shares the dual mandates of the Securities and Exchange Commission, investor protection and capital

formation. We are also aware of and appreciate the Committee's commitment to made recommendations that will have a real impact. SEMI commends the Committee for its willingness to make bold recommendations and challenge those who oppose them to prove their points. We encourage the Committee to hue to its course of carefully evaluating both costs and benefits of regulations, new and old.

### **Background on SEMI**

SEMI is an international industry association representing more than 2,000 companies globally – approximately 840 of which are headquartered in the United States and are involved in the semiconductor and flat panel display equipment and materials markets.<sup>1</sup>

SEMI's American publicly-traded companies make up a \$13 billion dollar industry. The vast majority of these companies are smaller and medium-size public companies. Some would be in the category on "microcap" companies described in the Draft. Many of our member companies are in their second year of complying with Section 404 of the Sarbanes-Oxley Act ("SOX"). Many SEMI members are "non-accelerated filers" under the Securities and Exchange Commission ("SEC") rules and are currently preparing for compliance with Section 404.

### **General Scope of SEMI Comments**

We support the ED's main recommendations. We support the recommendation that smallcap companies and microcap companies be relieved of some of the most costly requirements of SOX 404. We also believe that the SEC should designate "smallcap" and "microcap" categories of companies and scale its regulation in a cost effective way.

We have also reviewed the remainder of the Committee's recommendations and we certainly hope that the controversy surrounding the Committee's recommendations for a new

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<sup>1</sup> SEMI maintains offices in Austin, Beijing, Brussels, Hsinchu, Moscow, San Jose, Seoul, Shanghai, Singapore, Tokyo and Washington, D.C. We are committed to promoting transparent and high-quality financial reporting on a global basis. Among its many other functions, SEMI acts as a source of industry data and information, and facilitates open communication between the industry and investors, particularly the investment analysts who follow the industry and provide research to the investing public. See generally, [www.semi.org](http://www.semi.org).

approach to Section 404 compliance for smaller companies does not overshadow the other important recommendations in the Draft Report. Our comments focus on the two key recommendations discussed above and on three other recommendations in the Draft. Our comments on these latter three recommendations reflect our belief that there is a regulatory component to the shortage of analyst coverage for smaller companies. In addition, we want to explicitly support two recommendations in the Accounting Standards section which we think would have a particularly positive effect on smaller public companies if the SEC fully develops them.

Nearly every recommendation in the ED would have a positive impact. However, we believe that the Committee should focus the SEC's attention on a smaller number of primary recommendations. We believe that the five recommendations that we explicitly address in our comment would do the most to improve the situation of smaller technology-driven manufacturing companies such as those SEMI represents.

### **Detailed Comments on Most Important ED Recommendations**

#### **I. SEMI Supports the Draft's recommendations regarding SOX Section 404 internal controls evaluation, reporting and auditing.**

The primary benefit of internal controls over financial reporting is to provide all financial statement users -- management, board, audit committee, shareholders and the investing public - with a reasonable basis for reliance on the company's financial reporting. We believe that this goal can be accomplished without a disproportionate outlay of resources. Therefore, we have followed and contributed to various efforts to improve the cost-benefit equation in SOX Section 404 implementation.<sup>2</sup> As a consequence, we have experience upon which to assess the necessity of the bold recommendations in the Committee's ED.

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<sup>2</sup> SEMI filed a comment in December, 2005 on the COSO draft Guidance for Smaller Public Companies urging that the COSO revise its draft Guidance to more clearly respect the cost-benefit choices that boards of directors and executive managers of smaller public companies make in establishing, assessing and monitoring internal controls. SEMI also provided input to the SEC staff in May, 2005 as it developed its guidance document on "Year Two" 404 implementation.

SEMI supports the Draft's recommendations for significant relief from the requirements of SOX 404 for both categories of smaller public companies. SEMI members' experience with Section 404 mirrors the situation described in the ED and the experience of companies that has been widely reported.<sup>3</sup> Especially for smaller and mid-size companies the benefits in terms of financial reporting and internal controls have not justified the cost of Section 404 compliance. It is also well-documented that the cost of compliance with both SEC regulations and, especially the Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2,<sup>4</sup> has fallen disproportionately on smaller public companies.<sup>5</sup> Authoritative voices have suggested that this disproportionate impact arises from the fact that both SOX and the 1992 COSO guidance on internal controls were designed with large companies in mind. SEMI's analysis of the 2005 Draft *COSO Guidance for Smaller Public Companies* is that it would fail to mitigate this problem.<sup>6</sup>

SEMI member companies are committed to maintaining internal controls that provide reasonable assurance that the company has effective and efficient financial operations and reliable financial reports. As noted in the ED, internal controls in smaller companies tend to be less formal than in large companies. Moreover, controls that clearly exist may be difficult to document in a way that is worth the expense of doing so. They certainly need not be documented to the degree that is now demanded by audit firms in making their attestations on management's assessment of internal controls in order to be effective.

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<sup>3</sup> See, e.g., BNA, *SECURITIES LAW REPORTER*, "Witnesses Ask SEC Panel to Seek Amended SOX Rules for Smaller Firms" (June 20, 2005); American Electronics Association (AeA), *Sarbanes-Oxley Section 404: The "Section" of Unintended Consequences and its Impact on Small Business* (February, 2005). Available at [http://www.aeanet.org/governmentaffairs/gajl\\_sarbanesoxley1104.asp](http://www.aeanet.org/governmentaffairs/gajl_sarbanesoxley1104.asp).

<sup>4</sup>An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("AS-2").

<sup>5</sup> Press Release, October 5, 2005, *Survey Shows Companies Expect Cost of Sox Implementation to Decline Slightly in Second Year; Smaller Companies Expect No Cost Savings* (A survey conducted by the Nasdaq Stock Market and AeA found that public companies anticipate slight cost reductions during the second year of implementing Section 404 of SOX. However, "[s]maller companies, as defined as having market caps less than \$120 million, will see virtually no change in their costs."). Available at [aeanel.org](http://www.aeanet.org), *supra*, note 2.

<sup>6</sup> The SEMI December 22, 2005 comment letter on the COSO draft *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* is available at <http://www.ic.coso.org/coso/cosospc.nsf/COSO%20Public%20Comments%20Document.pdf>.

Getting the cost and benefits of internal controls right and “right-sized” has significance for investors. As we noted in our 2005 comment on the COSO draft guidelines:

It is important to remember that investors benefit from cost-effective internal controls and are harmed by requirements that cause waste. Investors in our industry are especially sensitive to this point. Excessively costly Section 404 compliance diverts resources that could otherwise be invested in ways that create value and enhance innovation -- new product development, for example. This ultimately affects the ability of American companies to compete with overseas suppliers and to retain technological leadership. The stakes are especially high when dealing with smaller companies since much of our innovative and competitive edge depends on them.<sup>7</sup>

Therefore, it is critical that the Committee strike the right balance between cost and benefit as it finalizes its recommendations on Section 404.

**a. SEMI supports the exemption for “smallcap” companies recommended in the ED.**

The ED correctly assesses the costs and benefits of SOX 404 compliance for smallcap companies. The Draft correctly describes the very different control environments in smaller companies compared to the large corporations for which Section 404, SEC rules and COSO guidance were written.

The Draft also correctly concludes that design and operations of internal controls in smaller companies are very different than in large ones. Relevant characteristics of smaller companies include limited staffing and resources to achieve adequate segregation of duties, management’s active involvement and oversight of financial operations and less complex information technology systems and controls. They must operate in a much more fluid environment in order to compete effectively. Therefore, benefits must be measured as carefully as costs in any new requirement, regulatory or otherwise.

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<sup>7</sup> *Id.*

The Draft correctly assesses SOX 404's excessive overall costs and undocumented commensurate benefits. As noted here and in the ED, the creation of shareholder value is as important as avoiding errors and detecting wrongdoing in a company's financial management. The ED clearly shows that the disproportionately higher costs for the thousands of smaller companies are not justified by any clear investor benefit. Therefore, SEMI supports the conclusion that exemption of smallcap companies from the auditor attestation requirement of SOX 404 strikes the appropriate balance.

**b. SEMI supports the ED's analysis regarding microcap companies.**

The ED properly concludes that microcap public companies present a special regulatory situation that warrants consideration in the high-cost Section 404 area. We support the ED's conclusion that microcap companies are particularly ill-suited to the Section 404 regime that has developed under SEC and PCAOB rules, COSO guidelines and audit firm practices.

The new requirements the Draft recommends regarding audit committees, certifications and codes of conduct are the types of internal controls that can be most effective in microcap companies. As noted in the ED, these would be new requirements for many microcap companies.

Should the SEC implement a conditional exemption for microcap companies, it could create a laboratory for experimentation on varying levels of internal controls compliance. SEMI believes that a broad exemption from many of the specific requirements of SEC rules on Section 404 would create an opportunity for companies to adopt all or parts of Section 404 compliance. It is frequently said that Section 404 requirements on internal controls enhance investor confidence and lower the cost of capital. If this is true and investors have greater confidence in companies that are "404-compliant," the consequent lower cost of capital should cause more companies to voluntarily comply. In this way the market could determine whether there is a cost-of-capital benefit from Section 404 compliance.

A voluntary system for evaluation and reporting on internal controls will encourage experimentation and variation in compliance so that the appropriate cost-benefit balance may

be discovered through creative approaches and full disclosure to public investors. Concepts like graded compliance in which audit firms provide limited attestations could be given an opportunity for testing. The frequency of 404 evaluation could also vary from company to company. Such variation, with full disclosure to the investing public, should help prove or disprove the value of the various requirements that follow from SOX 404. In the long run, this type of experimentation could show the way toward a more appropriate, more flexible approach to internal controls evaluation and reporting for all companies.

**c. “Better Implementation” is not a solution to the disproportionate cost of Section 404 compliance.**

Many arguments have been made in comment letters, separate Committee opinions and in the press in an effort to persuade the Committee to abandon its recommendations for significant exemptions from the provision of Section 404. The argument being made by accounting firms, among others, is that “better implementation” of 404 is the right approach for the Committee to recommend. A key aspect of this seemingly judicious recommendation is for further delay in 404 implementation and further study by the large accounting firms, the SEC, the PCAOB, etc. SEMI believes that the problem has been studied enough and that the available evidence shows that neither audit firm experience nor regulatory guidance will have any appreciable effect toward lowering 404 costs for smaller public companies.

Neither the SEC guidance nor the PCAOB guidance issued in 2005 have been shown to have had a measurable effect for smaller companies. The ED adequately explains why most smaller companies will realize no appreciable savings from routinization or repetition.

Indeed, it seems that whether the PCAOB’s AS-2 or another standard applies, the auditor attestation is going to drive cost. Furthermore, liability risk will ensure a conservative application and excessive documentation, verification and testing. The experience of accelerated filer companies shows beyond doubt that implementation is very expensive and the benefit to financial reporting is not commensurate. For these reasons, the call for more study seems most likely to result in little change from the status quo -- not the meaningful change in

the Committee's mandate. Therefore, the Committee should move forward with its recommendations for smaller company exemptions from at least some of the major aspects of Section 404.

**2. The SEC should designate separate smallcap and microcap categories of public companies and treat them separately for SOX 404 compliance and other regulatory purposes.**

The Committee's work has brought an important focus on the characteristics of the thousands of public companies that make up the smallcap and microcap sectors. The ED's recommendation on scaled regulation reflects some of the Committee's most important work and its analysis fully supports the recommendations it makes.

We appreciate and support the rationale behind the "six determinants" the Committee has chosen for differentiating companies. In addition, we understand the importance of market capitalization as a measure of investor exposure. However, we continue to believe that annual revenue is the better metric for compliance purposes -- and for internal controls compliance in particular. Therefore, we urge the Committee to reconsider whether revenue should be the key metric, rather than market capitalization, for determining public company size.<sup>8</sup>

**Detailed Comments on Other Important Committee Recommendations**

The ED contains many sound recommendations that deal with areas of great importance to smaller publicly-traded companies. Our comment letter will mention only a few of them. We seek to focus the Committee's recommendations on the most pressing problems of smaller public companies we represent. We see these three recommendations dealing with analyst coverage and accounting as among the most critical for the SEC to address in this area.

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<sup>8</sup> We recommend that the Committee consider, in defining the microcap and smallcap companies, higher revenue thresholds than the \$10 million and \$250 million in the ED. We believe that \$1 billion in revenue is, in fact, a better approximation of the right line to draw between large and smaller public companies.

Implementation of these recommendations would almost certainly have secondary benefits for all public companies and all investors for that matter.

**I. The SEC should adopt policies that encourage and promote the dissemination of research on smaller public companies (Recommendation IV.P.4.)**

Many changes in the business of third party analyst research have resulted in a decline in the research coverage for smaller public companies. For investors, this means less information available on smaller companies. For smaller companies, this means less interest on the part of investors – especially the sophisticated individual investors smaller public companies often seek as long-term owners. We see this as a paramount issue because the ability of our smaller members to function as publicly traded companies is dependent on maintaining a liquid market for their companies' stock. Broker-based analyst coverage is especially important for smaller companies which have a larger proportion of individual shareholders than larger companies, as the data developed in the Appendixes to the ED show. We therefore strongly urge the Committee to emphasize this recommendation in the final Report.

Like the Committee, we see the two specific recommendations in the ED as both important and non-controversial. There is a clear need for credible third-party research coverage for smaller companies that cannot attract the attention of “buy-side” analysts. The SEC should continue to permit fully-disclosed company-sponsored analyst reports. Similarly, the recommendation for continuation of brokers' use of “soft dollars” to support research by their clients is reasonable and appropriate.

In addition, we agree with the statement in the Draft that the “existing regulatory framework and business environment” exacerbate the decline in analyst coverage for smaller companies. Since regulation is an important aspect of the problem, we recommend that the Committee add one more aspect to its recommendations regarding analyst research. We believe the SEC can and should work with other regulators such as the NYSE and the NASD to evaluate the necessity of regulatory restrictions on analysts that inhibit coverage of smaller companies.

Regulators should evaluate whether all current restrictions on analysts are appropriate for the smaller investment banks that might chose to cover smaller companies. Moreover, we think it is a larger policy question whether the SEC's dual goals of investor protection and capital formation would be better served by analyst reports on smaller companies that run the risk of some transparent sales bias as opposed to a situation where there is no coverage of many companies at all. We think the Committee should encourage the Commission to address this issue in an open-minded way.

**2. The SEC should develop a “safe harbor” protocol for accounting for transactions that would protect well-intentioned preparer from regulatory action or legal liability when the protocol is appropriately followed (Recommendation V.P.I).**

New regulation, new regulators and new levels of risk have had a predictable effect on the accounting profession. It should not surprise the accounting regulators that accounting firms now are acting hesitantly and conservatively in the face of ambiguous transactions. Confusion, complexity and cost are the natural result of this tendency.

The ED's proposal for a safe harbor for such accounting determinations could be an important step toward solving this serious problem. As an organization that advocated for and has lived through the implementation of the safe harbor for forward looking statements in the securities laws, SEMI agrees with the suggestion that it is a good starting point for action in this area.

We urge the Committee to make this recommendation one of a small number of primary recommendations.

**3. The Committee should include secondary recommendation V.S.I regarding efforts to increase competition and choices in the accounting profession among the final Report's primary recommendations.**

The cost and service level in external auditing or accounting advice have been ongoing subjects of concern over the past several years. The lack of a sufficient number of real competitors in the top ranks of accounting firms is an obvious concern for all. These problems are most acute for smaller publicly traded companies.

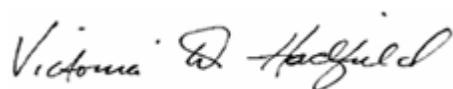
We are aware of the argument in other comment letters and public statements that exempting a large number of smaller public companies from Section 404 attestation requirements might actually increase the level of concentration in the accounting profession. In light of the stakes involved in Section 404 and the link between Section 404 requirements and the current supply-demand situation in accounting services, we believe the risk of an increase in concentration is less important than the potential benefit. Clearly, however, the overall impact of any regulatory change on competition should be monitoring closely.

We recommend placing this concern near the top of the Committee's priorities in order to raise its importance at the SEC.

## **Conclusion**

SEMI believes that the ED reflects the thorough consideration of an outstanding group of individuals. We commend the Committee for providing the kind of focus on known costs and demonstrable benefits that we hope will stand as an example for SEC regulatory action in the future. SEMI believes that the Committee's final Report will have the most benefit for smaller companies and their investors if it highlights the five recommendations discussed in this letter. We would be pleased to discuss these matters at any time.

Sincerely,



Victoria D. Hadfield

President, SEMI North America