

Statement for the Record

By

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives

June 5, 2007



Statement for the Record

Edward L. Yingling

on behalf of the

American **Bankers** Association

before the

Committee on Small Business

of the

United States House of Representatives

June 5, 2007

Madam Chairwoman and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). I am pleased to submit this statement for the record on behalf of ABA regarding the Sarbanes-Oxley Act of 2002 (Act) and its impact on small business. 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.

At the outset, I would like to recognize and thank Chairwoman Velázquez and Ranking Member Chabot for exploring the impact of the Act on publicly-traded small businesses and advocating on behalf of small businesses. This hearing is quite timely because, under the current Securities and Exchange Commission (SEC) rules, 2007 is the first year for which non-accelerated filers will be required to begin complying with the rules of Section 404, which has proven in many ways to be the most troublesome part of the Act.

The ABA fully supports the establishment and use of strong internal controls, which are critical to provide users of financial statements with reasonable assurance about the integrity of financial statements and to provide a foundation for appropriately managing a company's risks. However, we continue to be very concerned about the huge time and cost burdens experienced in complying with the Act, as well as business opportunity costs. The purpose of this testimony is to share those concerns from a community bank perspective and to provide some insights for your consideration.

The banking industry has had significant experience with management reporting on internal controls and auditor attestations, because the FDIC Improvement Act of 1991 (FDICIA), and the corresponding banking regulations, have required similar reporting for banks with total assets of \$500 million or more (recently raised to \$1 billion). Since then, banks have been required to produce annual reports on internal controls, and external audit firms have assessed the effectiveness of bank internal controls and have attested to these reports. Bankers, banking regulators, and accounting professionals have spent many hours specifically determining how to achieve such attestations. In fact, the Act used the FDICIA management report and attestation as its model. However, the rules surrounding the FDICIA process were re-written for Section 404 purposes, resulting in excessive work and costs.

The ABA would like to raise three issues or areas of concern:

- The need to update and to revise outdated rules related to registration and deregistration with the SEC;
- The implementation of the recently revised and finalized internal control rules – which must focus on cost reductions; and

- The application of Section 404 – which needs to be delayed for non-accelerated filers to give them the time to adjust to the updated rules.

The Shareholder Threshold for Registration Should Be Updated

All companies traded on a national exchange must register and file periodic reports with the SEC. In 1964, the Congress determined that these same reporting requirements should apply to companies that were not listed on an exchange but were still of a certain size to warrant SEC registration and reporting. Specifically, Congress determined that companies that have \$1 million in assets and 500 shareholders should be required to comply with federal securities law reporting requirements.

Since 1964, the SEC has twice raised the asset threshold to where it now stands at \$10 million but has failed to increase commensurately the 500 shareholder level. Although the SEC noted its intention to consider updating the shareholder threshold back in 1996, the shareholder level has, unfortunately, remained at the same level first set in 1964. The ABA strongly believes that it is time that this shareholder benchmark, set over 40 years ago, should be updated to reflect the realities of today's marketplace.

The ABA first raised this very important matter with then-SEC Chairman William Donaldson in a March 31, 2005 letter. Two years later, the matter continues to be of no less consequence to small public companies. For banks, in particular, the shareholder threshold is the essential determinative of whether an institution is “public” and therefore subject to the SEC's rules, including Section 404 of the Sarbanes-Oxley Act. ***By simply updating the shareholder threshold for SEC registration, the Committee could provide much needed regulatory relief to small***

businesses of all kinds, many of which are struggling to achieve Section 404 compliance for the current fiscal year.

While the SEC should be congratulated on its recent proposals to scale disclosure and reporting requirements for smaller publicly traded companies, these proposals are not enough to stop the outflow of capital from many smaller companies. As the Committee is aware, Section 404 and other recent regulatory mandates significantly affect the profitability of many small businesses. Community banks subject to Section 404 are no different, experiencing significant hits to earnings. For small institutions, 404 compliance represents an enormous financial burden.

Due to the increasing cost of being a registered public company, a number of small businesses, including some of our member community banks, have determined that deregistration is in the best interests of their shareholders. Under the implementing regulation of Section 12(g) of the Securities Exchange Act of 1934, Rule 12h-3(b)(1), companies that wish to deregister must either have less than \$10 million in assets or less than 300 record shareholders. Ninety-nine percent of domestic banks exceed the \$10 million threshold for registration, therefore, the only important criterion in the rule is the record shareholder threshold.

Reducing the number of shareholders to some number under 300 can be costly. Stock buybacks, reverse stock splits and the attendant legal costs are particularly expensive for small businesses. In addition, these transactions can have negative consequences for local communities. Besides reducing community banks' access to capital, it deprives small communities of one of the last opportunities to invest in a local business. Nevertheless, the high cost of Section 404 compliance is driving many bankers to choose this path.

Often banks do not choose to become SEC registrants, but are forced into it because of organic growth in shareholder ownership. Without marketing their securities, many community

banks have seen their shareholder base exceed the 500 mark as successive generations of shareholders distribute their shares amongst their descendents.

As mentioned earlier, the ABA believes it is imperative that the shareholder threshold is updated. In 1964, the indicator of a public market was determined to be 500 shareholders; it should now be revised to account for a more than threefold increase in the American populace investing in exchange-listed companies or 1,500. Alternatively, in 2007 dollars, after adjusting for inflation, the same market presence today that 500 shareholders would have occupied in 1964 would be six times as large. In other words, it would take approximately 3,000 shareholders today to equal the market presence of 500 shareholders in 1964, assuming the average number of shares held by each shareholder and the average price of each share have not changed. ***Accordingly, the ABA recommends updating the Exchange Act registration shareholder threshold to between 1,500 and 3,000 record shareholders. The threshold for deregistration should similarly be brought in line to between 900 and 1,800 record shareholders.***

On a related note, there has been some suggestion that the SEC should revise the shareholder threshold from the current “held of record” standard found in Section 12(g) to a “beneficial owner” standard. This definition is important because it provides the basis for calculating the number of shareholders for registration purposes. Under the current definition, persons identified in the issuer's records as security holders are considered “held of record.” This definition includes shares held in street or nominee name by financial intermediaries such as banks and broker-dealers. Expanding this definition to include “beneficial owners,” i.e., equitable owners of the shares, could have unintended consequences that need to be considered carefully.

Companies have great difficulty in determining, with any degree of specificity, the number of beneficial owners of its securities. With the advent of securities depositories (e.g., the Depository

Trust Company) and book-entry ownership of securities, it is not uncommon for shares to be held through various financial intermediaries, such as introducing and clearing brokers and downstream and correspondent banks. For example, a large bank may hold securities in nominee name for its own clients as well as those of a regional banking institution. The larger bank will, in turn, neither know the identity of the regional bank's customers nor whether that bank holds securities in nominee name on behalf of another smaller downstream community bank. This concept of "piggybacking," while efficient from a clearance and settlement perspective, frequently obscures the number and identity of the beneficial owners of the shares. In fact, the SEC has, itself, acknowledged the difficulty in accurately determining the identities of beneficial shareholders, as well as the financial costs associated with making such a determination, in a recently issued final rule liberalizing the means by which foreign issuers can deregister with the SEC.

No company, but especially a small company without the necessary resources to gather the requisite shareholder information, should be subject to registration as a publicly-traded company on the basis of information that is not within its ability to collect. Moreover, careful consideration needs to be given by both the Congress and the SEC to those small companies, especially small community banks, that are currently unregistered yet may become so under any move to redefine the shareholder threshold in terms of beneficial ownership. Such a move could force many small companies, especially smaller community banks, either to merge with a larger firm or substantially reduce their shareholder ownership, because they are unable to bear the new regulatory costs.

Implementation of the Rules Must Focus on Cost Reductions

Reducing costs and streamlining efforts will only be achieved if the auditing firms have the incentive to make efficiency a priority. Our primary concern with respect to implementation of

Section 404 involves the uncertainty as to auditor reactions to the combination of the SEC's final management guidance and the final auditing standards (AS-5) published by the Public Company Accounting Oversight Board (PCAOB). The first year of Section 404 saw exorbitant costs attributable to audit firms' over-testing and evident misinterpretation of the requirements of Section 404 and the PCAOB's auditing standards. Additional costs were incurred internally from hiring consultants and additional compliance employees to establish documentation and internal controls processes – much of which was unnecessary. These costs made severe dents in many companies' profitability without a commensurate return to shareholders.

In May 2005, to address some of the identified inefficiencies, the PCAOB issued guidance that was similar to some of what is now being more formally included in their rules. Although there was minor improvement in audit firms' reactions to the May 2005 guidance, it was insufficient. Clearly, time has passed and new audits are underway, which could result in further improvements; however, what is the incentive for audit firms to forgo this additional revenue, even if many clients and shareholders view it as over-auditing?

Efficiencies will only be successful if the auditing firms accept these streamlining efforts. The realization of the goals of these efforts will be measured by: (1) an evaluation by individual filers as to whether the work and costs are reduced; and (2) the inspections of auditing firms by the PCAOB. We believe that the SEC and PCAOB have achieved the proper balance with their new guidance, but ***monitoring the results will be extremely important in determining the success of the changes.***

The excessive burdens of Section 404 are also having an impact on small businesses that are not SEC registrants. For example, banks that are over \$1 billion in total assets and are not SEC registrants are not required to follow Section 404, but must continue to follow FDICIA.

Unfortunately, the auditing firms and the banking regulators are working to make FDICIA management reporting as burdensome as Section 404. ***This process should be stopped until we can better assess the effectiveness and efficiency of the new guidance and standards.***

In the auditing firms' move to integrate audits of internal controls with audits of financial statements for large public companies, smaller companies have been subjected to many of the requirements of Section 404 while not subject to those requirements by law. Thus, Section 404 has been costly – even to those banking institutions that are not SEC registrants. ***This one-size-fits-all approach to auditing does not work.***

Application Needs to be Delayed for Non-Accelerated Filers

Non-accelerated filers need a delay of the compliance date. We would like to take this opportunity to thank you, Chairwoman Velázquez and Ranking Member Chabot, for your attention to the problem of timing of compliance for non-accelerated filers. The Section 404 process was – and continues to be – a drain on company resources, and it is imperative that the rules are reasonable before requiring other small businesses to comply. We further believe that the effective date for compliance for non-accelerated filers should be delayed until such time as the new rules have been successfully implemented and evaluated for effectiveness.

In order to allow sufficient time for non-accelerated filers to implement the guidance in the SEC's interpretive guidance and auditors to adjust to using the PCAOB's new auditing standard, it is necessary to provide non-accelerated filers with adequate notice (a minimum of one full year in the case of calendar year companies) – in advance of required compliance – so that they have sufficient time to understand and implement the new guidance.

The previous extension granted to non-accelerated filers delayed the financial burdens of Section 404 and its concomitant strain on valuable resources until costs could be reduced through company and auditor experience, the issuance of additional guidance for management, and improvements in the compliance process. This extension prevented smaller companies from wasting valuable resources on unnecessary testing and overpaying consultants and auditors for unnecessary internal control work.

The clock is ticking with respect to non-accelerated filers. Non-accelerated filers, whose fiscal year coincides with the calendar year, are now required to report in their 2007 annual reports on their internal controls over financial reporting. We know that the SEC and PCAOB have done much to improve the Section 404 process through the recent adoption of management guidance and AS-5. We are concerned, however, that six months is insufficient time for smaller public companies and their auditors to digest all this new information. Placing such a significant time constraint on these smaller companies is unreasonable. Indeed, the SEC has yet to publish its new guidance or approve the final AS-5 – two actions that are vital for the smaller public companies to begin to get their arms around the Section 404 process. Consequently, the ABA is quite disappointed that the SEC has not granted an extension for non-accelerated filers. ***It is urgent that the SEC provide relief to these small businesses in a timely fashion.***

Based upon the recent public SEC meeting, there appeared to be agreement between the SEC and PCAOB that the new rules will significantly change the previous rules, providing the SEC with sufficient justification to provide the much needed delay. It should be noted that smaller audit firms will also need to develop internal guidance for their auditors to follow ***subsequent to*** the release of the final rules. In all likelihood, smaller companies will not want to begin their processes without agreement from their auditing firms, and there simply is not enough time for small companies to understand and implement the guidance successfully and efficiently to the satisfaction of their external

auditors. Ideally, non-accelerated filers should not be required to comply until the rules have been implemented and successfully tested for accelerated filers. This will help ensure that the efforts to improve the Section 404 process are actually working prior to requiring America's small businesses to comply.

In conclusion, the ABA appreciates your leadership, Chairwoman Velázquez and Ranking Member Chabot, on the Section 404 issues and the path you are taking toward making it a meaningful and efficient process for small businesses and investors alike.