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January 31, 2005

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-38-04
Release No. 33-8501
Proposed Rule: Securities Offering Reform

Dear Mr. Katz:

This letter is the response of BDO Seidman, LLP to your request for comments regarding the proposal listed above.

We support the principle embodied in the proposal that enhanced regulation of periodic reports filed under the Securities Exchange Act of 1934 should permit the regulatory framework for securities offerings to place greater reliance on those reports. We also support the Commission's initiative to modernize the offering process governed by the Securities Act of 1933. As such, we generally support the proposal. However, we have three primary concerns:

- We believe the Commission should expand the criteria to qualify as a well-known seasoned issuer to address the reliability of an issuer's reporting as well as its market following.
- We believe the Commission staff's study of market following demonstrates the need to change the market capitalization threshold in the definition of an accelerated filer from $75 million to $700 million.
- We believe the rules should require a new auditor's consent whenever there is a new effective date for a registration statement.

Our comments focus on these and other issues related to financial reporting and the role of the independent auditor in the registration process.

Definition of a Well-known Seasoned Issuer

We believe the Commission should expand the criteria to qualify as a well-known seasoned issuer to address the reliability of an issuer's reporting as well as its market following. In addition, we suggest that the Commission consider whether foreign private issuers should be required to provide more frequent and timely reporting in order to qualify.

Reliability

The criteria the Commission has proposed for determining whether an issuer qualifies as a well-known seasoned issuer and is given the privilege of automatic shelf registration focus on identifying issuers with wide market following. We agree that wide market following is a relevant and appropriate criterion. However, a key feature of automatic shelf registration is the ability to have registration statements become effective immediately upon filing, without the possibility of SEC staff review. Since the Commission plans to eliminate the possibility of SEC staff review from the registration process for these issuers, we believe it should expand the definition to address the reliability of their reporting. We believe the definition should include criteria designed to ensure that issuers qualify only if they have demonstrated the ability to consistently provide reliable financial information. We presume that with the enhanced SEC staff scrutiny of issuers' Exchange Act filings pursuant to Section 408 of the Sarbanes-Oxley Act, staff review of widely followed issuers' Securities Act filings should typically not be necessary. However, we believe the SEC staff should retain the option of reviewing those filings under certain conditions. We believe SEC staff review of registration statements, or the potential for review, is a potent tool for protecting investors and that the Commission should forgo the option of using it only when issuers meet appropriately high standards.

Below are examples of criteria the Commission should consider adding to the definition of a well-known seasoned issuer to address reliability of an issuer's reporting.

- <u>Size</u> – Market capitalization may not always serve as a reliable indicator that an issuer's external reporting function is sufficiently developed to warrant the privilege of automatic shelf registration. For example, during the late 1990s a number of start-up companies with limited operating history became registrants and were valued by the markets at remarkably high amounts. Given the limited amounts of these companies' personnel, we suspect that some of them may not have had a well-developed external reporting infrastructure.

  We suggest that including a size criterion in the definition would reduce the risk that an issuer with an inadequate external reporting function could qualify for automatic shelf registration. We suggest requiring a well-known seasoned issuer to have a specified level of annual revenue over a specified number of years, based on the assumption that a large, mature revenue stream correlates with having the funding to support an adequate number of qualified financial reporting personnel. For certain industries (e.g., financial services), total assets might be a more relevant criterion.

  We do not have a basis for suggesting the levels at which the Commission might set these criteria. The Commission's Office of Economic Analysis (OEA) recently studied attributes of issuers to determine which are widely followed. Perhaps the OEA could re-examine those issuers and identify the minimum level of revenue (or assets or other relevant criteria) reported by issuers that have been widely followed for a time period that suggests a reasonably mature external reporting function (perhaps three years).

We also suggest that size and market capitalization levels be integrated into one eligibility test, similar to the approach the Commission has used to govern entry into and exit from the small business issuer system. We do not believe an issuer's market capitalization temporarily falling below $700 million indicates an immediate loss of market following or that it should disqualify an issuer from well-known seasoned issuer status. By integrating size and market capitalization criteria, the Commission could avoid changes in status that are inconsistent with changes in an issuer's market following.

- <u>History of high-quality periodic reporting</u> – An issuer's reporting history with the Commission may be short or reflect errors in reporting. If so, we believe these factors raise sufficient questions about the reliability of its reporting to warrant disqualifying it from the privilege of automatic shelf registration.

  We suggest that the well-known seasoned issuer definition include a requirement for the issuer to have filed at least three annual reports. This would provide more time for the market to scrutinize its reporting. It would also ensure that at least one SEC staff review of its reports pursuant to Section 408 of the Sarbanes-Oxley Act had occurred. If any of the issuer's periodic reports filed during the three most recent fiscal years or the subsequent interim period contained a material error (as evidenced by announcing a restatement or filing restated financial statements or amendments of other disclosure to correct material deficiencies), we suggest that the issuer be disqualified until it has re-established an error-free three-year reporting history.

  We would not intend for such this criterion to disqualify all issuers that amend periodic reports. To the contrary, we would hope to avoid discouraging issuers from amending filings when they believe it would improve the disclosure. If the Commission adopts such a criterion, we suggest that it might reduce this risk by including commentary to this effect as well as a discussion of the types of amendments that would and would not disqualify issuers in the release accompanying the final rules.

- <u>Internal control over financial reporting</u> – Another way to identify and disqualify issuers whose reporting may be of questionable reliability would be to include a criterion based on material weaknesses in internal control over financial reporting.

  We are not suggesting that *any* issuer that reports a material weakness in internal control (and therefore, ineffective internal controls) be disqualified from well-known seasoned issuer status. For example, we do not believe that a single or small number of "narrow" material weaknesses, such as those related to specific account balances or transaction-level processes, raise sufficient reliability questions to disqualify an issuer. Indeed, we agree with the recent statement of the Commission's chief accountant, who said, "[W]e should expect in the coming months to see an increasing number of companies announce that they have material weaknesses in their controls. For this initial pass, that finding generally should not be surprising. Nor should it, by itself, necessarily be motivation for immediate or severe regulatory or investor reactions."[1]

On the other hand, material weaknesses in company-level controls, such as an ineffective control environment, an ineffective financial reporting process, or an ineffective audit committee are much more significant because they indicate that the foundation from which the issuer's external reports are built is weak.[2] We believe that significant weaknesses such as these should disqualify a registrant from well-known seasoned issuer status.

We acknowledge that drawing a distinction between "narrow" weaknesses related to specific account balances or transaction-level processes and "company-level" material weaknesses requires judgment and could be challenging operationally. However, users appear to be interested in understanding and being able to distinguish between material weaknesses in this manner.[3] If this drives issuers to communicate information about their material weaknesses in this manner, implementing such a criterion may not be so difficult.

We suggest that identifying a company-level material weakness should immediately disqualify an issuer, regardless of whether it is identified and disclosed in a quarterly report or in an annual report as a result of an audit of internal control. An issuer should remain disqualified until it remediates the weakness and its auditor attests to that remediation. (Sometimes company-level material weaknesses are identified in connection with restatements of financial statements. In those situations, we would suggest that the issuer remain disqualified until it has both remediated the material weakness and re-established an error-free three-year reporting history.)

Foreign Private Issuers

The proposal is based in part on the premise that widely followed issuers have a "more regular dialog with investors," particularly analysts and institutional investors, and are therefore subject to more frequent market scrutiny. The proposed well-known seasoned issuer definition would apply equally to domestic and foreign private issuers. However, foreign private issuers are not required to provide information as frequently or as timely as domestic registrants.

Since the "dialog" between foreign private issuers and investors does not appear to be comparable to that of a domestic issuer, we question whether foreign private issuers warrant the same automatic shelf registration privilege. We suggest that the Commission consider whether those foreign private issuers who wish to qualify for well-known seasoned issuer status should be required to report as frequently and timely as domestic issuers.

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[1] Speech by Donald T. Nicolaisen, December 6, 2004.
[2] The manner in which we are distinguishing between material weaknesses in internal control over financial reporting is consistent with the manner in which one significant financial statement user, Moody's Investors Service, has indicated it will evaluate material weaknesses. See *Special Comment: Section 404 Reports on Internal Control: Impact on Ratings Will Depend on Nature of Material Weaknesses Reported*, Moody's Investors Service, October 2004.
[3] See footnote 2.

Future Reconsideration

The Commission asked whether it should periodically reconsider the well-known seasoned issuer criteria and/or provide for automatic adjustments to them. We believe some re-evaluation would be appropriate in the future after the Commission has had more opportunity to observe the effects of its recent initiatives, particularly internal control reporting. We do not believe automatic adjustments are appropriate. We believe any adjustments should be based on analysis performed at the time and that the Commission should expose them for public comment in order to draw upon the experience gained by issuers, auditors, investors, and others before they become effective.

Definition of an Accelerated Filer

In the Commission's September 2002 release accelerating the reporting deadlines for certain registrants, the Commission stated that it designed the public float and reporting history requirements "to include the companies that are least likely to find such a change *overly burdensome* and *where investor interest in accelerated filing is likely to be highest*" (emphasis added). The Commission indicated that investor interest in accelerated filing is likely to be highest for companies followed by analysts and institutional investors because "[t]he more extensive information in periodic reports is evaluated by investors and particularly analysts and institutional investors as a baseline for the incremental disclosures made by a company." In addition, "investors, institutional investors and financial analysts" comprised the group of 20 commenters who supported acceleration as proposed.

In its study of market following, the OEA identified issuers with wide market following. The OEA equated wide market following with "[h]igh levels of analyst coverage [and] institutional ownership," among other criteria. The study indicates that the market capitalization level at which issuers become widely followed is $700 million. Thus, the study also indicates that the market capitalization level "where investor interest in accelerated filing is likely to be highest" is $700 million, not the $75 million figure reflected in the current accelerated filer definition. Therefore, we strongly believe the study supports changing the $75 million market capitalization threshold that triggers accelerated filing to $700 million and that the Commission should do so. If an issuer is not widely followed, we believe the cost of meeting the accelerated filing deadlines is "overly burdensome" and exceeds the benefit.

As we indicated in our comments on the definition of a well-known seasoned issuer, we do not believe an issuer's market capitalization temporarily falling below $700 million indicates an immediate loss of market following or that it should disqualify the issuer from well-known seasoned issuer status. Since both definitions are based on wide market following, we also do not believe that, once an issuer has become an accelerated filer, its market capitalization temporarily falling below $700 million should immediately eliminate the accelerated filing requirement. We believe the definitions of a well-known seasoned issuer and an accelerated filer should contain the same market capitalization and size tests and that the privilege of automatic shelf registration should be linked to an issuer filing on an accelerated basis. For debt issuers, we believe the privilege of automatic shelf registration should also be linked to accelerated filing. However, we believe that debt issuers that do not wish to take advantage of automatic shelf registration should not be required to file on an accelerated basis.

If the Commission is unwilling to revert to the 45/90 days due dates for quarterly and annual reports filed by issuers with market capitalizations in the $75-700 million range as we have recommended, we believe the results of the study of market following at least warrant retaining the current due dates for these issuers' periodic reports (40/75 days) and not accelerating them further (to 35/60 days).

Auditor Association with Prospectus Supplements

The proposal provides that in shelf registrations, filing a prospectus supplement would create a new effective date for purposes of Section 11 liability under the Securities Act, but a new consent would not be required from an independent auditor. It states, "[T]he new effective date would be for liability purposes only, would not, by itself, require the filing of additional consents of experts, and would not constitute an updating of the registration statement and prospectus for purposes of Securities Act Section 10(a)(3). For example, a prospectus supplement filed in connection with one or more takedowns of securities that did not include other disclosure for which the consent of an expert would be required pursuant to Securities Act Section 7 and Securities Act Rule 436 would not require consents to be filed or be considered the filing of a new registration statement."

The distinction between a new effective date as we understand that concept today and "a new effective date *for liability purposes only*" (emphasis added) is not clear to us. If the Commission proceeds with this, we recommend that it clarify this in the adopting release.

It is also not clear to us why, since a new prospectus supplement creates a new effective date for liability purposes, the Commission would not require updated experts' consents. The Commission seems to want the new effective date to ensure that the issuer and others with Section 11 liability (including experts) will consider whether the disclosure continues to be adequate and, in the event it is not, to update it. Yet, not requiring consents eliminates a mechanism that helps ensure that this process occurs.

The benefits of an auditor providing a consent are twofold:

1. It ensures that the auditor has the opportunity to provide himself with a due diligence defense pursuant to Section 11(b)(3) of the Securities Act.[4] The auditor establishes a due diligence defense by following the investigation procedures listed in AU Section 711 of the auditing standards adopted on an interim basis by the PCAOB. These investigation procedures address the Commission's concern, i.e., whether the disclosure continues to be adequate.

[4] Section 11(b)(3) of the Securities Act provides that an expert would not be liable if that person had, after reasonable investigation, reasonable ground to believe and did believe, at the time the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

2. It protects investors by enabling the auditor to fulfill his traditional gatekeeper role. If during the course of performing AU Section 711 procedures the auditor discovers potential errors and/or omissions that he is unable to resolve to his satisfaction, he would not give his consent. This would serve to halt a securities offering that might otherwise be misleading.

The proposal appears to impose liability on the auditor without providing him with an opportunity to protect himself, while at the same time restricting his ability to protect investors. Accordingly, we strongly object to it. To effectively address these concerns, the final rules should require a consent from the independent auditor at the initial effective date of a registration statement, at the date of any post-effective amendment, upon the filing of an annual report that creates a new effective date, and upon the filing of any prospectus supplement that creates a new effective date.

Ineligible Issuers Under Rule 405

The Commission has proposed to define in Rule 405 a category of issuers termed “ineligible issuers.” Ineligible issuers would not qualify for well-known seasoned issuer status. They would also be prohibited from proposed incorporation by reference in Forms S-1 and F-1.

Well-Known Seasoned Issuer Status

With respect to the issuers listed in this rule being disqualified from well-known seasoned issuer status, we support the proposal. We also support the proposed provision that would allow the Commission, through its staff, to waive ineligibility in appropriate circumstances.

In the release, the Commission asked whether disqualification based on a going concern opinion would cause undue pressure on auditors to not issue those opinions. The Commission also asked whether it should replace that disqualification criterion with alternative criteria such as whether an issuer had (1) net losses or negative cash flows from operations for two or more of the past three annual fiscal periods or (2) a deficit in net worth at the date of the most recent balance sheet. We do not believe the going concern criterion would put undue pressure on auditors to not issue such opinions. However, we believe the going concern opinion criterion is not as effective as the Commission’s alternatives in promptly identifying issuers with significant liquidity problems. For example:

- Operating and liquidity problems can arise (or worsen) subsequent to the date of an auditor’s report on the latest annual financial statements. If the issuer received a “clean” opinion on its latest annual financial statements but its financial condition has deteriorated, the issuer should be disqualified. However, under the proposed going concern criterion it will not be.

- Given the standards for issuing a going concern opinion, that criterion will identify a relatively limited group of companies with potentially significant liquidity problems. We believe it would be preferable to establish criteria that would cast a net wide enough to catch substantially all issuers whose liquidity problems warrant disqualification.

Therefore, we believe alternative criteria such as those identified by the Commission would better identify such issuers.

Incorporation by Reference in Forms S-1 and F-1

The Commission has proposed amendments to Forms S-1 and F-1 that would allow Exchange Act registrants meeting specified criteria to incorporate by reference previously filed Exchange Act reports in Form S-1 or Form F-1. Ineligible issuers would not be granted this accommodation. Given the high degree of access that market participants have to an issuer's financial information on the SEC's website, we no longer regard printing company information in a prospectus vs. incorporating it by reference as a substantive distinction. As such, we believe all Exchange Act registrants should be able to incorporate by reference previously filed documents into Form S-1 or Form F-1, presuming, of course, that they have filed all required reports.

We also agree with the proposed elimination of Forms S-2 and F-2.

Risk Factors Disclosure in Exchange Act Filings

In its proposal, the Commission asks whether it should require issuers to disclose risk factors in Forms 10 and 10-K, as well as to update these disclosures on an interim basis in Form 10-Q. We believe that meaningful disclosure of the risks a company faces is useful to investors. Therefore, we support the proposal. We believe the challenge for the Commission is to find an approach that will result in meaningful disclosure, instead of boilerplate or a list of risk factors that is so long that a reader cannot identify what is important.

One approach would be for the Commission to require Regulation S-K Item 503(c) disclosures in Exchange Act reports as proposed and issue interpretive guidance in an effort to enhance issuers' Item 503(c) disclosures. (We believe risk factors disclosure should be improved, and we suggest that the Commission consider issuing interpretive guidance regardless of the approach it takes on the proposal.) This would have the benefit of consistent requirements for Securities Act and Exchange Act filings. However, we expect that the Commission would have more success in eliciting meaningful disclosure in Exchange Act reports if it wrote a rule for Exchange Act reporting purposes that is different from Item 503(c) of Regulation S-K.

We believe the objective of any separate Exchange Act rule should be to require periodic reports to limit the discussion to those risks that are the most important or "critical" (similar to the approach in Financial Reporting Release 60 (Release 33-8040) and the approach reflected in the rules the Commission proposed regarding critical accounting policies (Release 33-8098)), rather than requiring an issuer to address all of the most significant risks potentially affecting it.

Regardless of whether the Commission develops a separate rule, we suggest that changing the specified location of the disclosure might also help. We fear that placing the risk factor disclosures in a new Item 1A next to the discussion of the business as proposed could promote an undesirable tendency to disclose *all* risks that may affect the entity and its various segments, products, services, and other topics discussed in the business section, rather than only the most important or critical risk factors. We believe that a meaningful discussion of risk factors is more closely aligned conceptually with the discussion of material known trends and uncertainties required in management's discussion and analysis of financial condition and results of operations. Therefore, we suggest that the Commission designate risk factors as Item 7A of Form 10-K and renumber quantitative and qualitative disclosures about market risk as Item 7B. By positioning disclosure of risk factors as a "supplement" to an Item 7 MD&A discussion, perhaps those drafting the disclosure would be more inclined to "link" the approach for identifying risks in Item 7A to the approach in Item 7 for describing how material risks are reasonably likely to affect the issuer and management's plans for addressing them.

Although the Commission has not proposed to extend risk factor disclosures to small business issuers, we believe this would be appropriate. Since a small business issuer's resources—be they human, capital, or otherwise—are generally less than those of larger issuers, similar risks may have disproportionately larger consequences to them. Therefore, an investor in a small business benefits from meaningful risk disclosure at least as much as an investor in a larger business.

Unresolved SEC Staff Comments

The proposal asks two questions with respect to the treatment of material unresolved SEC staff comments. First, should automatic effectiveness for shelf registration statements only be granted upon their clearance, and second, should accelerated filers be required to disclose them in their annual reports? We do not believe either of these approaches should be adopted because there are currently sufficient incentives for an issuer to address staff comments in a timely manner.

We believe all parties involved in a capital raising transaction are keenly aware of the heightened legal risk they face if capital is raised using a registration statement containing financial statements or other disclosure that subsequently needs to be restated or amended. This provides a common incentive for issuers, their audit and disclosure committees, external auditors, outside counsel, and others to ensure that there are no material unresolved staff comments at the time of an offering. As the Commission is aware, an issuer offering securities in a registered offering must obtain the consent of named experts. As part of the due diligence and other procedures they perform, the professionals involved typically ensure that all material issues are resolved before an offering proceeds.

For the same reasons as outlined above, we believe that disclosing unresolved staff comments in annual reports is also unnecessary. In addition, we believe that the issuers to which this provision would apply—accelerated filers, who are widely followed and scrutinized by the market—have generally been sensitive to staff comments and committed to resolving them in order to provide timely and reliable financial information.

We believe the Commission should instead focus on a different aspect of the staff's comment process. Currently, a registrant has no knowledge of whether a staff review of its periodic reports is in process. We expect that most issuers, if they knew comments were forthcoming, would strongly consider delaying an impending takedown off an effective shelf registration statement (or a new, automatically effective registration statement) until they had had a chance to see and consider the staff's comments. We believe such a result would be in the best interest of investors.

Therefore, we suggest that the Commission consider instructing its staff to notify an issuer when it has commenced a review of a filing for which it expects to issue comments.

If the Commission decides to proceed with the proposed annual report disclosure requirement, we believe the 180-day period put forth in the proposal is a reasonable period of time to resolve outstanding staff comments, presuming the SEC staff promptly considers and communicates its views on an issuer's response. We suggest the SEC staff be obligated to reply to issuers' responses to comments on Exchange Act filings in an amount of time that is commensurate with the time it took the issuer to respond to the staff's comments, but not less than a reasonable minimum (perhaps 5-10 business days, depending on the number and significance of the comments).

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We appreciate this opportunity to express our views to the Commission. We would be pleased to answer any questions the Commission or its staff might have about our comments. Please contact Wayne Kolins, National Director – Assurance Practice, at (212) 885-8595 or via electronic mail at wkolins@bdo.com, or Lee Graul, National Director – SEC Practice, at (312) 616-4667 or via electronic mail at lgraul@bdo.com.

Very truly yours,

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