Testimony

Of

Thomas Venables

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business and Entrepreneurship

United States Senate

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Mr. Chairman and members of the Committee, my name is Thomas Venables. I am Chief Executive Officer of Benjamin Franklin Bancorp, Inc. in Franklin, Massachusetts. My community bank has $913 million in total assets, employs 186, and was chartered over 130 years ago. I am pleased to be here today to represent the American Bankers Association (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.

Before I go any further, we would like to recognize and thank Chairman Kerry and Ranking Member Snowe for their efforts in advocating an extension of the compliance deadline for non-accelerated filers. This hearing is 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.

First, let me say that 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 a significant amount of 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.

By way of background, my own company, Benjamin Franklin Bancorp, achieved full compliance with Section 404 as of December 31, 2006. It may be helpful to share several facts related to our efforts during 2006 in this regard. Our team of officers and employees involved in the Section 404 effort expended 2,214 hours during 2006 at a cost of $180,082. In addition, we incurred an ***increase*** of internal audit costs of $113,080, information technology (IT) audit costs of $48,680, and additional external audit costs of $78,000, for a grand total of $419,842. During this time, we decided not to employ the services of an outside Section 404 "expert," or the costs would have been even higher. ***This expenditure of time and money has not improved our ability to manage the bank.*** The FDICIA controls that we have had in place for years are more than adequate to provide a framework for management to assess and report on the effectiveness of our internal controls. To put the approximately $420,000 of Section 404-related expenditures in perspective, this amount represents 6.1 percent of normalized 2006 earnings! It is not enough to be struggling with an inverted yield curve and tremendous loan and deposit competition in our markets, but to start off the earnings year at 94 percent of potential because of the Section 404 compliance costs – well, this is difficult. Our shareholders were not well served, as the costs outweighed the benefits. My experience is not unusual. In fact, most community banks report significant hits to earnings from these costs.

Given my experience with Section 404, I would like to raise three areas of concern:

- the revised and reformed rules – which need to be finalized with utmost speed;
- the implementation of the rules – which needs to 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 Rules Need to be Finalized with Utmost Speed

The rules appear to be improving. The ABA appreciates the significant work the SEC and the Public Company Accounting Oversight Board (PCAOB) have done to provide management guidance and improve the auditing standards. We support the SEC's position that streamlining of this guidance is important for both large and small registrants, as implementation costs have been too high and need to come down.

Chairman Cox and Chairman Olson, particularly, should be commended for their efforts to streamline the Section 404 process to make it more cost-effective. They have focused on the appropriate areas, and the new guidance and auditing standards are clearly headed in the right direction. Their proposals provide efficient guidance and standards for management and auditors that have the potential to reduce costs of compliance for all filers while retaining the strong investor protections and risk focus of Section 404. Those proposals, which reduce the level of prescriptive detail (by shifting from transactions-based to risk-based audits) and eliminate unnecessary duplication of work, will, hopefully, make the Section 404 process more efficient and less costly. Thus, this will be a win-win for investors and the companies in which they invest. ***The proposed guidance from the SEC and proposed auditing standards from the PCAOB need to be finalized with utmost speed.***

Another set of rules, those related to shareholder threshold for SEC registration, must be updated as well. ***Updating the shareholder threshold for SEC registration is a specific action that could appropriately flow from today's hearing as a step that would immediately reduce***

regulatory costs on small businesses consistent with protection of shareholders. I would be remiss to not discuss this with you, the Senate Committee on Small Business and Entrepreneurship. This topic is of utmost importance to small businesses, and, without amending Section 404 itself, it would have an impact on the application of Section 404 by small businesses.

Due to the increasing cost of being a registered public company, a number of small businesses, especially 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. Because ninety-nine percent of banks exceed the $10 million threshold for registration, the only criterion of importance to our member institutions in the rule is the record shareholder threshold. Thus, it is very difficult for most community banks to deregister without buying back shares from investors to retain fewer than 300 record shareholders. Doing so, however, can have negative consequences for local communities. Besides reducing small bank access to capital, it deprives small communities of one of the last opportunities to invest in a local business. Nevertheless, the high costs of Section 404 compliance drives many bankers to choose this less than best option.

Often banks do not choose to become SEC registrants, but are forced into it because of the 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. Recently, these same institutions have seen the cost of compliance with Section 404 and other recent regulatory mandates significantly impact the profitability of the company. Community banks subject to Section 404 are experiencing significant hits to earnings. For small institutions, this amount represents an enormous financial burden.

Although the SEC noted its intention to consider updating this threshold back in 1996, the shareholder level has remained at the same level since it was first set in 1964. At that time, the indicator of a public market was determined to be 500 shareholders. This indicator is now overdue for a revision to account for a more than threefold increase in the American populace investing in exchange-listed companies. 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 3000 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 1500 and 3000 record shareholders. The threshold for deregistration should similarly be brought in line to between 900 and 1800 record shareholders.***

On a related note, it is our understanding that the SEC's Division of Corporation Finance is considering a notice of proposed rulemaking on the definition of "held of record" found in Section 12(g). Under the current definition, only 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, would not only make it difficult to determine the number of shareholders for purposes of the registration requirements, but could significantly affect smaller companies. Under such an approach, many currently unregistered community banks and small companies would be required to register under the Exchange Act and incur all the concomitant costs of being a public company. If the SEC were to take such a step, we

believe that many of our smaller community banks will be forced either to sell up or substantially reduce their shareholder ownership, because they are unable to bear the new regulatory costs.

Implementation of the Rules Needs to 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 published by the 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 inefficiencies being identified, the PCAOB issued guidance that was similar to some of what is now being proposed for more formal inclusion 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 reviews of auditing firms by the PCAOB. We believe that the SEC and PCAOB have achieved the proper balance with their proposals, 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. Thus, Section 404 has been costly – even to those banking institutions that are not SEC registrants. This process should be stopped until we can better assess the effectiveness and efficiency of the new guidance and standards.

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, Chairman Kerry and Ranking Member Snowe, for your attention to the problem of timing of compliance for non-accelerated filers. Although my institution is a small business, we are an accelerated filer and a delay for non-accelerated filers does not benefit us. However, I know firsthand how draining the Section 404 process was – and continues to be – on our resources, and it is imperative that the rules are reasonable before requiring other small businesses to comply. We fully agree with your letter to Chairman Cox on the need for an additional delay, and 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 proposal and auditors to adjust to using the PCAOB's new auditing standards, 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 are not expected to invest in outdated processes and have sufficient time to understand and implement any new guidance.

The previous extension granted to non-accelerated filers delayed the financial burdens of Section 404 and the strain on valuable resources until costs could be reduced through experience, additional guidance for management, and improvements in the compliance process. This prevented these 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, and the alarms are ringing. We know that the SEC and PCAOB are working diligently to finalize their rules. We are concerned that at the close of the most recent Section 404 meeting of the SEC there was no mention of a specific delay of the compliance date for non-accelerated filers. ***It is urgent that the SEC provide relief to these small businesses in a timely fashion.*** 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. In order to comply properly with this requirement, non-accelerated filer management must decide ***now*** whether to follow the old rules or whether to follow the proposed rules, which are supposed to be completed sometime this summer. Moreover, once the proposals have been issued in final form, both audit firms and registrants must quickly read and understand the final rules, and then apply them. Placing such a significant time constraint on these smaller companies is unreasonable.

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 current 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 and I appreciate your leadership, Chairman Kerry and Ranking Member Snowe, on the Section 404 issues and the path you are taking toward making it a meaningful and efficient process for small business and investors alike. We are glad this Committee is focusing on these issues that are so important to America's small businesses.