COUNCIL OF INSTITUTIONAL INVESTORS

Via Hand Delivery

April 18, 2007

The Honorable John F. Kerry
Committee on Small Business and Entrepreneurship
United States Senate
SR-428 Russell Senate Office Building
Washington, DC 20510-6350

Re: April 18, 2007, Hearing of the Committee on Small Business and Entrepreneurship titled "Sarbanes-Oxley and Small Business: Addressing Proposed Regulatory Changes and their Impact on Capital Markets"

Dear Mr. Chairman:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over $3 trillion. On average, Council members have more than fifty percent of their domestic equity holdings invested in indexed funds, including significant investments in the Russell 3000 index which includes many newer, smaller businesses that are not represented by the S&P 500 or other large indexes. Your hearing today, therefore, raises very important and timely issues of great interest to our members in their role as institutional investors. We respectfully request that this letter be made a part of the official hearing record.

The Sarbanes-Oxley Act of 2002 ("SOX") was enacted in response to a shocking series of corporate scandals, including many resulting, at least in part, from lax or inadequate internal controls. The costs of these scandals—from company-specific losses to a widespread loss of confidence in the integrity of the U.S. capital markets—were staggering. All investors in the U.S. markets, from large institutional investors to individuals investing their hard-earned savings, were impacted by these frauds.

The internal control requirements of Section 404 are a core element of SOX and play a vital role in restoring and maintaining investor confidence in the markets. Consistent with the requirements of Section 404, the Council believes any company tapping the public markets to raise capital, regardless of size, should have appropriate internal controls.

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Smaller public companies have long been especially prone to misstatements and restatements of financial information.[1] Thus, sound internal control over financial reporting of the generally riskier smaller public companies is as important to Council members and many other investors as the quality of the internal control over the financial reporting of larger public companies.

Implementation of Section 404 is substantially improving companies' internal controls. The number of restatements filed by large public companies, which adopted Section 404 in 2004, fell by nearly twenty percent in 2006, the first such decline since 2001.[2] By contrast, the number of restatements by smaller public companies with a public float of less than $75 million, so-called "non-accelerated filers" that have yet to adopt Section 404, increased in 2006 by forty-two percent.[3]

The Council acknowledges that the initial costs of compliance with Section 404 have been higher than anticipated, and that some companies, particularly some smaller companies, have struggled in implementing its requirements. Some of the outlays can be attributed to expected one-time start-up costs associated with complying with any new regulatory requirement.[4] Other outlays include "deferred maintenance" expenditures required to make up for years of neglect of internal controls—controls that public companies, including smaller public companies, have been required to have in place since 1977, the year the Foreign Corrupt Practices Act ("FCPA") went into effect.[5]

The Council agrees that more might be done to further reduce the costs of compliance with Section 404, particularly for smaller public companies. We, therefore, generally support the U.S. Securities and Exchange Commission's ("SEC") proposed interpretative guidance, *Management's Report on Internal Control Over Financial Reporting*,[6] and the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals*.[7] We believe that the guidance contained in those proposals, expected to be finalized before the end of June, should assist smaller public companies and their external auditors in implementing Section 404 in a more cost-effective manner.

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[1] *See, e.g.*, Carlo di Floria, *COSO Study on Fraud in Financial Reporting* 4 (Oct. 1999) (available at http://ww1.transparency.org/iacc/9th_iacc/papers/day3/ws7/d3ws7_cdflorio.html) ("In the past decade, most fraud in financial reporting among public companies was committed by smaller corporations, with well below $100 million in assets.").
[2] David Reilly, *Restatements Still Bedevil Firms,* Wall St. J. C7 (Feb. 12, 2007).
[3] *Id.*
[4] *See, e.g.,* Mark Grothe et al., *Glass Lewis & Co.*, The Error of Their Ways 13 (Feb. 27, 2007).
[5] *Id.* at 15-16.
[6] Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* 2 (Feb. 13, 2007).
[7] Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Office of the Secretary, *PCAOB* 2 (Feb. 13, 2007).

The Council strongly believes that any further deferral or extension of the effective date of Section 404 for "non-accelerated filers" is *not* in the best interest of investors. As indicated above, our members on average have more than fifty percent of their domestic assets invested in index funds, including the Russell 3000 index. If, as you have proposed,[8] non-accelerated filers are permitted a *fifth* delay,[9] forty-two percent of the Russell 3000, or nearly 1,300 public companies, would not be required to fully comply with the Section 404 requirements until 2010. Thus, the application of a crucial component of SOX would not occur for more than *seven* years after SOX was enacted, and more than *thirty* years after enactment of the internal control requirements of the FCPA.[10]

In conclusion, Section 404 was enacted as key part of a regime of important investor protections. The time has come for all public companies to prepare to fully comply with all the requirements of Section 404.

We again appreciate the opportunity to provide the Committee with our views on this issue. We would be happy to respond if you have any questions or need additional information.

Sincerely,

Jeff Mahoney
General Counsel

CC: The Honorable Olympia J. Snowe, Ranking Member, Committee on Small Business and Entrepreneurship
The Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission
The Honorable Mark W. Olson, Chairman, Public Company Accounting Oversight Board

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[8] Letter from The Honorable John F. Kerry, Chair, and The Honorable Olympia Snowe, Ranking Member, *Committee on Small Business & Entrepreneurship* to The Honorable Christopher Cox, Chairman, *Securities and Exchange Commission*, and The Honorable Mark W. Olson, Chairman, *Public Company Accounting Oversight Board* 1 (Feb. 23, 2007).

[9] Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* 2-3 (Sept. 14, 2006) (Commenting on the prior four delays).

[10] We also note that there is some anecdotal evidence that some smaller public companies have not taken advantage of the four previous delays of the Section 404 requirements to prepare for the implementation of those requirements. *See, e.g., PCAOB Member: In Some Ways, SOX Inevitable*, WebCPA (Sept. 13, 2006). We are not confident that a fifth delay will change that behavior.