

COUNCIL OF INSTITUTIONAL INVESTORS

Via Hand Delivery

April 24, 2007

The Honorable Christopher J. Dodd
Committee on Banking, Housing, and Urban Affairs
United States Senate
SD-534 Dirksen Office Building
Washington, DC 20510-6075

Re: Senator Jim DeMint Amendment to S. 761, the "America Competes Act."

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.

It is our understanding that later today Senator Jim DeMint plans to offer an amendment to S. 761, the "America Competes Act" that would make Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") optional for most public companies.¹ The purpose of this letter is to express our concerns with Senator DeMint's amendment.

As you are well aware, 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 Council believes that 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, we also believe any company tapping the public markets to raise capital, regardless of size, should have appropriate internal controls.

¹ Dear colleague letter from the Honorable Jim DeMint, United States Senate (Apr. 20, 2007).

The Council observes that smaller public companies have long been especially prone to misstatements and restatements of financial information.² Moreover, a recent analysis of materiality and reporting errors found that (1) reporting errors at smaller public companies “tend to be more significant” than those of larger companies;³ and (2) smaller public companies “are more likely to sit on errors that decrease earnings than big companies.”⁴ 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.

The Council also observes that 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 2001.⁵ 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.⁶

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.⁷ 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 went into effect.⁸

² See, e.g., Carlo di Floria, *COSO Study on Fraud in Financial Reporting* 4 (Oct. 1999) (available at http://www1.transparency.org/iacc/9th_iacc/papers/day3/ws7/d3ws7_cdfiorio.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.”).

³ Jack T. Ciesielski, *Out of Sight, Out of Mind: Staff Accounting Bulletin 108*, 16 *Analyst’s Acct. Observer* 9 (Apr. 16, 2007).

⁴ *Id.* at 8.

⁵ David Reilly, *Restatements Still Bedevil Firms*, *Wall St. J. C7* (Feb. 12, 2007).

⁶ *Id.*

⁷ See, e.g., Mark Grothe et al., *Glass Lewis & Co., The Error of Their Ways* 13 (Feb. 27, 2007).

⁸ *Id.* at 15-16.

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*,⁹ 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*.¹⁰ 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.

The Council strongly believes that any change to Section 404 that would make the requirements for internal control only voluntary for some public companies 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 Senator DeMint has proposed, Section 404 would be optional for public companies "with market capitalization of less than \$700 million, revenue of less than \$125 million, or few than 1,500 shareholders,"¹¹ more than 1,000 public companies within the Russell 3000 index would not be required to comply with a crucial component of SOX.

⁹ Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission 2* (Feb. 13, 2007).

¹⁰ Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Office of the Secretary, *PCAOB 2* (Feb. 13, 2007). Of note, the general membership of the Council of Institutional Investors recently adopted the following policy supporting the independence of the Public Company Accounting Oversight Board:

Independence of Accounting and Auditing Standard Setting

Audited financial statements and their related disclosures are a critical source of information to institutional investors making investment decisions. The well-being of the financial markets—and the investors who entrust their financial present and future to those markets—depends directly on the quality of the information audited financial statements and disclosures provide. The quality of that information, in turn, depends directly on the quality of the standards that: (1) preparers use to recognize and measure their economic activities and events; and (2) auditors use in obtaining reasonable assurance that the preparers' recognition and measurement is free of material misstatement. The result should be accurate, transparent, and understandable financial reporting.

The responsibility to issue and develop accounting and auditing standards should reside with independent private sector organizations with an appropriate level of government input and oversight. Those organizations should possess adequate resources and the technical expertise necessary to fulfill this important role. Those organizations should also include significant representation from investors and other users of audited financial reports on the organizations' boards and advisory groups. Finally, those organizations should employ a thorough public due process that includes solicitation of public input on proposals and consideration of user views before issuing final standards. The United States Congress, the Securities and Exchange Commission ("SEC"), and other federal agencies and departments should respect and support the independence of the designated accounting and auditing standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies. (adopted March 20, 2007).

¹¹ Dear colleague letter from the Honorable Jim DeMint, *supra*.

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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 would be happy to respond if you have any questions or need additional information about the views of institutional investors on this very important matter.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeff Mahoney". The signature is written in a cursive style with a large initial "J" and "M".

Jeff Mahoney
General Counsel

cc: The Honorable Richard C. Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs