

# COUNCIL OF INSTITUTIONAL INVESTORS

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## Via Email

February 13, 2007

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

*Re: File Number S7-24-06*

Dear Ms. Morris:

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. As a leading voice for long-term, patient capital, the Council believes that Section 404 of the Sarbanes-Oxley Act of 2002 has been critical in restoring investor confidence and the overall integrity of the United States (“US”) capital markets and welcomes the opportunity to comment on the US Securities and Exchange Commission’s (“SEC”) proposed interpretive guidance, *Management’s Report on Internal Control Over Financial Reporting* (“Proposal”).

We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are the backbone of high quality financial reports. All companies tapping the public markets to raise capital, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

Section 404 is improving companies’ internal controls. A recent study revealed that 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.<sup>1</sup> By contrast, the number of restatements by smaller public companies with a public float of less than \$75 million, which have yet to adopt Section 404, increased in 2006 by forty-two percent.<sup>2</sup>

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<sup>1</sup> David Reilly, *Restatements Still Bedevil Firms*, Wall St. J., February 12, 2007, at C7.

<sup>2</sup> *Id.*

In May 2006, following our participation on the SEC and Public Company Accounting Oversight Board (“PCAOB”) Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions, we provided several broad-based recommendations to the SEC and PCAOB.<sup>3</sup> Those recommendations were designed to “preserve the investor protections provided by Section 404”<sup>4</sup> while addressing those legitimate concerns raised by some parties about certain difficulties and costs<sup>5</sup> in implementing the Section 404 requirements. They included the following:

*The SEC should offer guidance, in plain English, to management . . . on how to assess the effectiveness of internal control over financial reporting.*

. . .

*The Council recommends that guidance tailored to the unique issues faced by smaller companies . . . be issued.*<sup>6</sup>

The Council believes the Proposal is largely responsive to the Council’s recommendations and we strongly support its prompt adoption and implementation as a final rule.<sup>7</sup> We also offer the following brief comments on the Proposal’s application to smaller public companies—an area of particular interest to Council members.

### **Smaller Public Companies**

On average, Council members have more than fifty percent of their US equity holdings invested in indexed funds, including significant investments in the Russell 3000 stock index. Moreover, the evidence indicates that smaller public companies are especially prone to misstatements and restatements of financial information.<sup>8</sup> Thus, management’s evaluation, assessment, and reporting on the internal control over financial reporting of the generally riskier smaller public companies is as important to our members and many other investors as an evaluation, assessment, and reporting on the internal control of larger public companies.

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<sup>3</sup> Letter from Ann Yerger, Executive Director, *The Council of Institutional Investors*, to The Honorable Christopher Cox, Chairman, *U.S. Securities and Exchange* and The Honorable Bill Gradison, Acting Chairman, *Public Company Accounting Oversight Board* 2-3 (May 17, 2006).

<sup>4</sup> *Id.* at 2.

<sup>5</sup> Of note, Glass, Lewis & Co., LLC., has reported that a review of company filings for the Standard and Poor’s 500 indicates that audit fees as a percentage of revenues *declined* in 2005. Lynn Turner, Remarks at the Duke-ILEP Conference on Reform Proposals of Committee on Capital Market Regulation and U.S. Chamber of Commerce 37 (February 2, 2007).

<sup>6</sup> *Letter from Ann Yerger*, at 2-3.

<sup>7</sup> *Cf.* Letter from Jeff Mahoney, General Counsel, *The Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* 2-3 (September 14, 2006) (Explaining why a “serial extension of the Section 404 requirements” is not in the best interests of investors).

<sup>8</sup> *See, e.g., Lynn Turner*, at 24.

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We support the Proposal's "top-down, risk-based approach"<sup>9</sup> and agree that the approach "should enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances."<sup>10</sup> We, however, would respectfully request that the final rule emphasize that scaled or tailored evaluation methods and procedures for smaller public companies do not mean less rigorous evaluation methods and procedures.

We would also respectfully request that the final rule clarify that management is required to evaluate the size *and* complexity of their company when determining whether their company is a "smaller public company" for purposes of implementing the interpretative guidance. Thus, we would generally oppose permitting the scaling or tailoring of evaluation methods and procedures based solely on the rules-based size limits contained in the final report of the SEC Advisory Committee on Smaller Companies.<sup>11</sup> We note that (1) there is no evidence that we are aware of indicating that the size of a company decreases the risk of misstatements,<sup>12</sup> and (2) our proposed clarification would resolve a potential incompatibility with the PCAOB's proposed auditing standard.<sup>13</sup>

The Council appreciates the opportunity to comment. We would be happy to respond if you have any questions or need additional information.

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney".

Jeff Mahoney  
General Counsel

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<sup>9</sup> Management's Report on Internal Control Over Financial Reporting, Release Nos. 33-8762; 34-54976; File No. S7-24-06, 17 (December 20, 2006).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 17 n. 44.

<sup>12</sup> *Cf.* COSO, Internal Control over Financial Reporting—Guidance for Smaller Companies, FAQ, Item 19 (June 2006) ("Size of the organization does not decrease the need for effective internal control").

<sup>13</sup> Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit Of Financial Statements, PCAOB Release No. 2006-007, ¶ 9 (December 19, 2006).