CFA INSTITUTE | Centre for Financial Market Integrity

3 April 2006

Jonathan G. Katz
Committee Management Officer
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-9309

***Re: File Number 265-23***

Dear Mr. Katz,

The CFA Centre for Financial Market Integrity ("CFA Centre" or the "Centre")[1], in conjunction with its Capital Disclosure Policy Council (the "Council"), appreciates the opportunity to provide comments on the Exposure Draft of Final Report of Securities and Exchange Commission's (SEC) Advisory Committee on Smaller Public Companies (ACSPC). The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide on issues affecting the quality of financial reporting and disclosures provided to investors.

The Council strongly opposes the major thrust of the ACSPC's report, which is to provide most SEC registrants partial to full exemption from the requirements in Section 404 of the Sarbanes-Oxley Act of 2002. Furthermore, we find the Committee's primary (or first tier) recommendation to establish a scaled system to determine whether individual securities regulations should be scaled based on the company's size to be most troublesome. As investors, as well as investment professionals, we view any scaling system for securities regulation to be a "slippery slope" which will lead to less reliable, relevant and timely financial reporting and disclosures. Overall, we believe that if this recommendation is implemented there would most likely be a decline, and/or no improvement, in the quality of information available to investors of smaller public companies.

[1] The CFA Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 81,600 investment professionals in more than 126 countries of which more than 67,500 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 132 Member Societies and Chapters in 53 countries and territories.

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***Our perspective***

The Council comprises investment professionals who manage investments and/or provide advice to investors for making decisions about whether to buy, sell or hold positions in a company's securities. As such, investments are made in companies of all sizes and across industry sectors, sometimes with a concentration in small-cap and micro-cap companies. Therefore, we are aware of the risks and rewards associated with such companies, including the market and regulatory factors that may affect their operations, and ultimately, their financial performance and financial condition.

In our view, there are certain characteristics common to many smaller public companies that must be considered in this debate, including their tendency to have:

- Less market coverage by investment banks, research analysts and media
- Lower market liquidity;
- Minimal to no corporate relations with investors, who are fewer in number and principally individuals rather than institutional investors;
- Inadequate accounting expertise and unsophisticated internal control systems which lead to more frequent restatements of previously reported financial information;
- Lower thresholds of materiality; and
- Higher volatility of reported earnings and risk of financial distress;

Given these characteristics, smaller public companies, and investors in these companies, are faced with the following consequences and market dynamics:

- Investments in these companies are inherently riskier because unexpected events often have a relatively greater effect on the investments' value given the limited capacity of these companies to absorb adverse events.
- Similarly, the deviations from market expectations, including restatement of previous financial information, have a greater impact on a company's share price due to lower market liquidity and fewer large shareholders.
- Investors in smaller companies are even more dependent on relevant, accurate and complete financial information regarding past performance, and data needed to project future sales, earnings, and cash flows.
- Smaller companies are more dependent on outside consultants for accounting expertise and implementing effective internal controls.

***The need for Section 404***

Therefore, we strongly disagree with the ACSPC recommendation to scale back, or exempt, smaller public companies from having to comply with Section 404 requirements. We believe that adequate internal controls are a necessary element within the financial reporting framework. This notion is not new. Since 1977, public companies have been required to have a system of internal controls and auditors have assessed the effectiveness of these controls in determining the extent of their audit procedures.

Furthermore, research affirms the need for smaller public companies to have adequate and effective internal controls in place. In the late 1990s, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) conducted a study analyzing fraudulent financial reporting between 1987 and 1997. The 1999 report noted that most fraud in financial reporting among public companies was committed by smaller corporations, with well below $100 million in assets. It also highlighted that the violation of laws, regulations and policies were generally the result of deficiencies in corporate governance and internal controls.

In conclusion, the COSO report provided investors, financial professionals and regulators with valuable information by directing the focus of their efforts. For example, a regulatory focus on companies with market capitalization over $200 million may inadvertently fail to target those companies that most frequently engaged in fraud. We believe that the findings of the COSO report are still germane and should not be ignored[2].

***An independent examination of internal controls***

We believe that an independent testing and assessment of internal controls is essential in delivering quality information to investors which is relevant, accurate and complete enough for investors to make well-informed investment decisions. History has shown that simply requiring companies to have in place an effective system of internal controls with the expectation that auditors would test those controls has not produced compliance. The external testing of the existence and effectiveness of the controls, and the reporting of the testing results to investors, must be part of the framework to ensure that there is compliance.

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[2] Mr. Carlo di Florio's comments at the 9th Annual International Anti-Corruption Conference in 1999 – under Section IV - Summary of COSO Study on Fraud in Financial Reporting -PRINCIPLE FINDINGS.
http://ww1.transparency.org/iacc/9th_iacc/papers/day3/ws7/d3ws7_cdflorio.html

***Tailoring the independent exam to the company's operations***

We understand that there is no current requirement in Section 404 stipulating that a standardized "one-size-fits-all" exam of internal controls must be performed. Although this may have been the approach applied to initially implement the requirements of Section 404, we suggest that a tailored approach would be more appropriate, especially for smaller public companies. Companies have varying degrees of operational and financial risks associated with their business activities and transactions and therefore, require different types, and level of, internal controls to address their own diversity and/or complexity of risks.

To provide further elaboration of our views, we have attached Kurt Schacht's, Executive Director of the CFA Centre for Financial Market Integrity, statement dated 23 February 2006, as **Attachment I** to our letter.

***Costs and benefits of implementing Section 404***

Although the requirements of Section 404 may result in relatively higher costs for small companies, the potential benefits are also greater. We believe such benefits include:

- Increased investor confidence and valuation metrics (such as the price/earnings ratio) and possibly a decrease in share price volatility resulting from higher financial statement reliability and lower risk of unexpected adverse outcomes.
- Better quality management decision making as a result of better and more reliable financial information.

Investors bear the costs, although indirectly, as well as receive benefits from a company's implementation of effective and adequate internal control system. Therefore, as investors, we consider these implementation costs to be investments in a company, which should provide long-term benefits. Again, please refer to **Attachment I** for further elaboration of our views.

## Closing Remarks

We have seen improvements in governance, internal controls, and greater transparency through more timely and detailed information being provided to investors. Efficient and liquid capital markets rely on investors' confidence in the ability of those markets to provide full, fair and accurate disclosures. The capital markets comprise of all sizes of companies which present varying risks and rewards.

In summary, we believe that:

1. Requirements in Sarbanes-Oxley Act of 2002 should apply to all public companies, regardless of size.
2. Accounting standards, disclosures and reporting requirements, such as segment disclosures and interim reporting, should not vary by company size but rather be based on the complexity and diversity of a company's operations, activities and transactions.

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comments to the ACSPC's report dealing with the application of Section 404 of the Sarbanes-Oxley Act. If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

*/s/ Patricia A. McConnell*

Patricia A. McConnell, CPA
Chair
Corporate Disclosure Policy Council

*/s/ Georgene B. Palacky*

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Senior Policy Analyst
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Rebecca McEnally, CFA, PhD, Director of Capital Markets Policy Group, CFA Centre
Kurt Schacht, CFA, JD, Executive Director of the CFA Centre
Ray DeAngelo, Managing Director, Members and Society Division, CFA Institute

# Attachment I

**SEPARATE STATEMENT OF KURT SCHACHT, CFA**

**EXECUTIVE DIRECTOR, CFA CENTRE FOR FINANCIAL MARKET**

**INTEGRITY**

**Relating to the**

**FINAL REPORT OF**

**THE SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES**

**February 23, 2006**

This Separate Statement to the Final Report of The Advisory Committee on Smaller Public Companies (the "Report") is submitted for the purpose of dissenting on several of the primary recommendations of the Advisory Committee. These relate to the work of the sub-committee on Internal Controls Over Financial Reporting (the "Sub-Committee"). As a member of the Sub-Committee and consistent with our dissenting opinion of December 14, 2005, we remain opposed to key portions of the Report.

Observers and committee participants agree that the most substantive recommendations in the Report, relate to the application of Section 404 of Sarbanes-Oxley ("Section 404") to smaller public companies. As a Committee, we reviewed several issues impacting smaller public companies. It is clear however, that the impacts of Section 404, particularly the resource demands and costs of implementing 404, have proven to be the most challenging. During our deliberations, the Sub-Committee discussed dozens of ways and options for reducing costs, while maintaining investor protections.

**Cost-Benefit Analysis**

The Advisory Committee members generally agree that the costs of Sarbanes Oxley ("SOX") are the real issue. While minimization of regulatory costs is always a desirable goal, the Report confirms what we knew coming into this Committee process, that the costs have exceeded all estimates, and have significantly impacted small companies. There have been numerous cost studies and other anecdotal comments on whether these costs are, or will be, coming down in subsequent years. The evidence will only be clear once we have actual data in the coming months. For many companies that have yet to go through the process, the initial costs will be high. But the analysis must not end there. It suggests that whatever the benefits of Section 404 might be, they are surely far outweighed by these more obvious cost figures. The Report states that the benefits are of less certain value and moves on to other matters.

The Advisory Committee, by and large, agrees that internal controls over financial reporting at public companies are important. More specifically, we assert they are an important feature for accurate financial reporting, investor protection, and market integrity. But is there a measurable benefit? It is impossible to measure the value of a

financial/accounting fraud avoided. In 2005, there were approximately 1300 restatements and weaknesses in financial reporting revealed and fixed by a Section 404 inspired process, more than double the number in 2004. This dramatic increase will have an inestimable and far-reaching impact on financial reporting reform. Some argue this is a reflection of deferred maintenance on an internal controls process that has been neglected and that SOX represents a renaissance for proper internal control process and environments. Whatever the reason, these are benefits that are significant and certain. Moreover, they are benefits which we believe, balance the cost of a properly scaled and verified internal control structure.

**Section 404 Exemption vs. Improved Section 404 Implementation.**

The Sub-Committee set about its work with the focus of adjusting the main cost driver of Section 404, the level to which internal controls need to be documented, verified and tested by management and outside auditors. The original objectives were to reduce the cost burdens but maintain the investor protections associated with Section 404. The Sub-Committee focused on a variety of ways to meet the objectives but narrowed its attention to two. The first is creating a more tailored and cost-efficient internal control structure and verification process for small companies, i.e. reducing the cost and resource drain of Section 404 through better implementation. The second is providing small companies with an exemption from the main requirements of Section 404.

The objectives of cost control and investor protection need not be mutually exclusive. However, the Report's primary recommendations make them so. Our strongest objection is that the Report recommends a flat-out exemption from all auditor 404 involvement in reviewing and confirming internal controls. This is not for just a few, but for what will effectively be more than 70 to 80 percent of the public companies in this country.

One could cite any number of flaws in this approach, but several in particular stand out:

- First, the entire premise of SOX was to bolster investor confidence by requiring meaningful corporate governance and financial reporting reforms. Likewise, maintaining investor protections is a primary tenet of the Committee Charter. Properly designed and functioning internal controls over financial reporting were and are a cornerstone of this legislation. Proper structuring and implementation of 404 requirements are very different from eliminating these completely for a broad segment of U.S. companies. That approach works against the statute's legislative intent and the directive that we heard from both Chairman Donaldson and Chairman Cox.

- Second, it is unclear to many whether the broad exempting recommendations of this subcommittee are even within the commission's legal authority. Comprehensive, sweeping exemptions from Section 404 may not be possible under the current legislation, which specifically excluded Section 404 from the Securities and Exchange Act of 1934. As the full Commission works toward final recommendations, it would be well served to resolve that potential legal uncertainty so as to avoid further litigation delays in addressing Section 404 concerns.

- Third, with regard to Micro Caps as defined, the Report recommends exemptive from not only auditor involvement in reviewing internal controls but also exempts the managers of these firms from having to do their own internal assessment of such controls. Essentially, no one has to check the design, implementation and effectiveness of internal controls over financial reporting at these companies. The reason for this complete 404 exemption according to the Report is that there is no specific directions/guidance available to such small company managers to know how to create an appropriate internal control structure. We wonder about two things in this context. First how have these firms been able to meet the on going legal requirements for maintaining an effective system of internal controls (actually mentioned as part of the recommendation) and more importantly, if such guidance is missing for micro caps, how does it suddenly become clear for managers of small companies above $125 million in market cap? In the event any of these exemptive recommendations are adopted by the

SEC, we believe logic dictates that managers in all public firms be required to complete an annual Section 404 assessment of internal controls.

- Fourth and maybe most important, small public companies need checks and balances over financial reporting. This includes the Section 404 checks and balances in our view. The Report indicates that: small cap firms have less need for internal controls; requiring external verification of internal controls is a waste of corporate resources; and, that better corporate governance is a substitute for such verification. It further suggests that investors in these companies don't particularly care about internal control protections and that these companies represent an inconsequential bottom 6% of total U.S. market capitalization, rendering even an Enron-like blowup, a minor event. At the same time, the Report characterizes such small companies as a critical link in economic growth and competitiveness and that Section 404 is the regulatory tipping point and barrier to accessing public markets. Parsing through these contrasting views of inconsequential vs. critical seems to suggest incorrectly that venture capital exit strategies are more important to protect than public investors providing risk capital. A number of experts we heard from feel that properly structured and verified internal controls are probably more important for the riskier, smaller firms and that additional corporate governance provisions are in no way a substitute for properly working internal controls. For example, these small firms consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms, according to one report. Alarmingly, these small firms also make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998-2003).

- Finally, we note that as part of each of the recommendations for Section 404 exemption, the Report suggests these companies be reminded of pre-SOX legal requirements to have an effective system of internal controls in place. This legal reminder simply points out how ineffective the rules were pre-SOX and how they are no substitute for having some level of external verification of controls as prescribed by Section 404.

**Better Implementation of Section 404 & SOX "LIGHT".**

A more balanced approach to fixing the cost concerns of Section 404 is to continue requiring manager assertions and auditor attestation of internal controls, but direct the appropriate regulatory and de facto standard-setting bodies (the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the Public Company Accounting Oversight Board) and the SEC to develop specific guidance for small companies. This approach has been referred to as a "404 Light" or "SOX Light" approach. However, the term has become confusing over the course of the Committee debate.

Much of the outline for this approach appeared in preliminary recommendations of the Sub-Committee. We encourage the Committee to be clear on the options for better implementation and for the Commission to consider a broad range of approaches. These may include: 1) reviewing/refining the existing AS-2 standards; 2) possible development of an alternative auditing standard (the Report references AS-X) that provides for a meaningful, but more cost effective audit; and 3) development of specific directives from COSO and PCAOB on how to "right-size" for small issuers, the control structure, the requirements for managers assessment and the scope of an internal controls audit.

This "Better Implementation" approach appears in the Report, but comes only as a fall-back alternative to the exemptive recommendations. To ensure continued investor confidence in our markets, we support the approach that preserves the investor protection aspects of 404 while lowering costs to implement and verify proper internal controls over financial reporting.

**Investors Support Section 404.**

It is clear that we need to do something for small companies. Investors in these companies, more than anyone, have a significant stake in making sure we balance the regulatory burden with the need to grow and access capital markets. Investors and the economy are ill-served by a system that neglects either.

We heard commentary from several professional investors and institutional managers in support of Section 404 requirements. The weight of such testimony has

been questioned since many do not invest directly in micro cap firms. Moreover, the lack of specific individual testimony from micro cap and small cap investors along with the observation that people still invest in these firms without Section 404 protections, both in U.S. and foreign markets, has been suggested as evidence that investors do not care about section 404 protections.

While we encourage more of these small company investors to come forward and participate in the next comment period, we believe the investor base involved in these firms is very fragmented. These companies represent somewhere between 70 and 80 percent of public companies and collectively have millions of individual retail and private shareholders. It is unlikely this group will magically coalesce and speak with a collective voice on this or any other regulatory or financial reporting issue affecting the companies in which they invest. That silence should not be misinterpreted. These are precisely the investors that need the formal and self-regulatory "system" to provide the necessary protections, transparency and honesty that ensures a fair game. It is what continues to make U.S. markets the gold standard.

We appreciate the opportunity to serve on the Advisory Committee and to serve as a representative for investor views. We encourage investors to provide timely commentary to this Report. As with any regulation, it is important to reach the proper balance between cost burden on the issuer and investor protection. We firmly support realignment and better implementation, not elimination of Section 404, as the proper balance.