



May 10, 2006

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

**RE: File Number 4-511 Sarbanes-Oxley Act, Section 404 Internal Control Reporting Requirements**

Dear Ms. Morris:

The Free Enterprise Fund is a leading membership organization that promotes the American system of free enterprise, including lower taxes, market-based regulation, and limited government. We appreciate the opportunity to comment on the internal control reporting and auditing provisions of the Sarbanes-Oxley Act's Section 404 and the Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2.

We believe that Sarbanes-Oxley, though well-intentioned, was rushed into law without the proper deliberations and insight of the business community. In addition, and contrary to conventional wisdom, we do not feel that Sarbanes-Oxley played a significant role in restoring investor confidence.

Indeed, empirical evidence now strongly suggests that the net-effect of Sarbanes-Oxley has been to actually *decrease* investor confidence and *cloud* corporate transparency, by forcing private companies to stay that way, even if they once desired to go public--turning this rationale for maintaining the law, in its present form, on its head.

The staggering costs of Sarbanes-Oxley bear repeating. An analysis by Ivy Xiying Zhang of the University of Rochester measured the total stock market impact of the law as costing over \$1 trillion dollars. Perhaps a third of that loss reflects direct compliance costs; the other hundreds of billions of dollars are a result of the economic inefficiencies created.

The investor-confidence rationale is not sound as it holds that whatever the costs of Sarbanes-Oxley have been, the costs of inaction would have been greater. Indeed, if the markets were in freefall as a result of the corporate scandals, then such a case could be made. But markets soon shrugged off the scandals without any major sell-off.

An analysis by Peter Wallison of the American Enterprise Institute found that the stock market continued to rise in the wake of the Enron scandal, and while the Dow ticked down six points the day of the Worldcom scandal's revelation, it jumped 150 points the following day, and held that gain over the next six trading days. Only when news of an

aggressive legislative response broke did stocks begin their decline, with the Dow dropping 462 points in the two days President Bush called for reform.

Zhang exhaustively examined the market response to all of the significant events leading to passage of Sarbanes-Oxley and concluded that the loss of market value surrounding those events totaled \$1.4 trillion. She compensated for other factors that contributed to those losses and concluded that the market losses that can be attributed to Sarbanes-Oxley amount to about \$1 trillion.

Still, the proponents of Sarbanes-Oxley continue to insist that the law is critical to investor confidence. By extension, they argue that Section 404 is necessary, and oppose exemptive relief for smaller companies.

A novel study by Professor Kate Litvak of the University Of Texas School Of Law provides the best evidence yet to the contrary. Prof. Litvak compared foreign companies who are subject to Sarbanes-Oxley (because they are listed on U.S. exchanges) with analogous foreign companies not subject to the law. She found that investors expected Sarbanes-Oxley to have a *net negative effect* on companies forced to comply. That is to say, the benefits, whatever they may be, are less than the costs as far as investors are concerned. No wonder companies have so often cited Sarbanes-Oxley as a reason for fleeing U.S. stock markets by going private or shifting their listings to London or Hong Kong.

Participants in early-stage entrepreneurial investing no longer view the public capital markets as an exit strategy, instead looking exclusively to acquisitions or expensive mezzanine financing from private equity or hedge funds. These companies lose because they face a higher cost of capital. Investors lose because the most innovative, entrepreneurial companies are no longer available as investments to ordinary individual investors.

Section 404 should be made voluntary, especially for smaller public companies that face the largest compliance costs relative to revenues. Companies that choose to comply would--if supporters of Section 404 are correct--enjoy higher investor confidence as a result. A second-best solution would be to adopt the tiering suggested by the SEC Advisory Committee on Smaller Public Companies, providing exemptive relief for the smallest companies and reducing the burden of compliance for medium-sized companies.

Sincerely,

A handwritten signature in black ink, appearing to read "Mallory Factor". The signature is fluid and cursive, with a prominent flourish at the end.

Mallory Factor  
Chairman