March 21, 2006

The Honorable Christopher Cox  
Chairman  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549


Dear Chairman Cox:

I, and the many law professors who appear on the attached co-signers’ page, join in this letter to express our deep reservations regarding the legal authority of the Securities and Exchange Commission to exempt “micro-cap” registrants from the provisions of section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). The proposed exemption appears in the draft report of the SEC’s Advisory Committee on Smaller Public Companies and, pursuant to the definition set forth in the draft, the exemption would remove nearly eighty percent of all U.S. public companies from the requirements of section 404.

As law professors whose research and teaching focus on securities regulations, we have examined the permissible scope of the SEC’s authority to promulgate exemptions pursuant to section 36(a) of the Securities Exchange Act of 1934. It is our opinion that section 36(a) of the Securities Exchange Act, or for that matter section 3(a) of Sarbanes-Oxley, does not empower the SEC to exempt issuers from section 404 of Sarbanes-Oxley.

Our conclusion is compelled by the below underscored language of section 36(a):

[T]he Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person . . . or any class or classes of persons . . . from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The expression “of this title” refers to Title I of the Exchange Act. Thus, section 36(a) does not reach other securities law statutes that are within the SEC’s jurisdiction, for example the Public
Utility Holding Company Act of 1935, the Investment Company Act of 1940 or the Investment Advisers Act of 1940. Because section 404 of Sarbanes-Oxley is not part of the Exchange Act, it falls outside section 36(a). This conclusion is supported by the committee report accompanying the enactment of the National Securities Markets Improvement Act of 1996 which explains the exemptive authority being provided in both section 28 of the Securities Act and section 36(a) to the Securities Exchange Act as applying only to the provisions of their respective titles.

“This section adds a new Section 28 to the Securities Act to provide the Commission with the authority, by rule or by regulation, to conditionally or unconditionally exempt any person, security, or transaction, or any class of the same, from any provision or provisions of the Act or any rule or regulation thereunder. . . . The legislation adds a new Section 36 to the Exchange Act to provide the Commission with authority under the Exchange Act similar to that contained in new Section 28 of the Securities Act.” See H.R. Rep. 104-622, 1996 U.S.C.C.A.N. 3877, at 3900-01

The conclusion that “of this title” refers only to the Securities Exchange Act is further supported by this same expression appearing in section 28 of the Securities Act, section 6(c) of the Investment Company Act, and section 206A of the Investment Advisors Act. Thus, each of these major acts expressly authorize the SEC to establish exemptions but only for “any provision or provisions of this title.” When each of these sections are considered, the inescapable conclusion is that none of them provide authority for the SEC to create exemptions other than from the provisions of the particular act whose exemptive authority the SEC has invoked for that exemption.

The Congress, by not imbedding section 404 of Sarbanes-Oxley in the Exchange Act as it did with so many of its other Sarbanes-Oxley provisions, thereby chose to remove section 404 from the SEC’s authority to exempt reporting companies from the requirements of section 404. The exclusion of section 404 from the Exchange Act is particularly revealing in view that Exchange Act Section 13(b)(2)(B) mandates that reporting companies “devise and maintain a system of internal accounting controls. . . .” If Congress had desired section 404’s requirements to be subject to Exchange Act qualification or exemptions that the SEC can adopt pursuant to section 36(a) of the Exchange Act, the natural step for Congress to have taken when enacting section 404 was to cast it as an amendment to Section 13(b)(2). Congress did not do this.

The conclusion that Congress intended all reporting issuers to be subject to section 404, and therefore beyond the power of the SEC to adopt exemptions under section 36(a) of the Exchange Act, is further supported by the language of section 404 which requires that the SEC “prescribe rules requiring each annual report” of a reporting company include assessment by management of internal controls as well as the independent auditor’s attestation of management’s assessment. Congress certainly envisioned that management’s assessment and the auditor’s attestation would occur for “each annual report” of reporting companies. Hence, a broad exemption, in addition to being outside the powers the SEC has under section 36(a) of the Exchange Act would also be inconsistent with Congress’ clear intent in adopting section 404. Given this conclusion, we also do not believe that section 3(a) of Sarbanes-Oxley can reasonably be read to provide such authority.

The preceding analysis does not mean, however, that the SEC and PCAOB are without authority to tailor section 404 requirements differently for smaller issuers. Sarbanes-Oxley does not authorize the SEC to grant exemptions from its provisions. Instead Sarbanes-Oxley in section 3(a) of Sarbanes-Oxley requires the SEC to promulgate rules and regulations “in furtherance of this Act” that are “in the public interest or for the protection of investors.” Specific disclosure
requirements tailored to unique risks and likely regulatory benefits of specific classes of registrants are entirely appropriate and consistent with the rulemaking authority the SEC enjoys under section 3(a) of Sarbanes-Oxley.

We believe a far wiser course for the SEC and the PCAOB is to closely evaluate the reporting risks associated with internal controls of various issuer classes and develop an appropriate framework for section 404 compliance by smaller public companies. In making this evaluation the SEC and the PCAOB should understand that there is abundant empirical evidence that financial reporting violations most frequently involve companies whose market capitalization does not exceed $250 million. This approach is far more consistent with the SEC’s overall mission than if it were to grant a sweeping exemption, which we believe is unlawful, of nearly eighty percent of reporting companies from any internal control assessment by its senior management and attestation by the firm’s auditors.

Respectfully yours,

James D. Cox
Brainerd Currie Professor of Law

cc: Paul A. Atkins, Commissioner
    Roel C. Campos, Commissioner
    Cynthia A. Glassman, Commissioner
    Annette L. Nazareth, Commissioner
Co-Signers of Letters

Jeffrey D. Bauman  
Professor of Law  
Georgetown University Law Center

Rutheford B. Campbell, Jr.  
Law Alumni Professor of Law  
University of Kentucky College of Law

John C. Coffee, Jr.  
Adolf A. Berle Professor of Law  
Columbia University School of Law

Stuart R. Cohn  
Gerald A. Sohn Research Scholar  
Levin College of Law, University of Florida

Roger J. Dennis  
Professor of Law and Provost  
Rutgers, State University of New Jersey, Camden

Jill E. Fisch  
Alpin J. Cameron Professor of Law  
Fordham Law School

Theresa A. Gabaldon  
Professor of Law & Carville Dickinson Benson Research Professor of Law  
School of Law, George Washington University

Mitu Gulati  
Professor of Law  
School of Law, Duke University

Thomas Lee Hazen  
Cary C. Boshamer Distinguished Professor  
School of Law, University of North Carolina

Robert W. Hillman  
Fair Business Practices Chair and Distinguished Professor  
School of Law, University of California, Davis

Lyman Johnson  
Robert O. Bentley Professor of Law  
Washington and Lee Law School
Therese H. Maynard
Professor and Leo T. O’Brien Fellow
Loyola Law School, Los Angeles

Alan Palmiter
Professor of Law
Wake Forest School of Law

Frank Partnoy
Professor of Law
University of San Diego School of Law

Margaret V. Sachs
Robert Cotton Alston Professor of Law
University of Georgia School of Law

Mark A. Sargent
Dean and Professor of Law
Villanova University School of Law

Marc I. Steinberg
Rupert & Lillian Radford Professor of Law
Southern Methodist University Dedman School of Law

Steve The1
Wormser Professor of Law
Fordham Law School

Randall S. Thomas
John S. Beasley Professor of Law and Business
Vanderbilt University Law School