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COUNCIL OF INSTITUTIONAL INVESTORS

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August 26, 2005

Jonathan G. Katz
Committee Management Officer
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-9303

Re: File Number 265-23

Dear Mr. Katz,

The Council of Institutional Investors, an association of more than 130 public, corporate and union pension funds with combined assets of more than $3 trillion, is pleased to provide input to the SEC Advisory Committee on Smaller Public Companies on the potential impact of the Sarbanes-Oxley Act of 2002 on small businesses.

The Sarbanes-Oxley Act was adopted in the wake of a series of high-profile, shocking scandals and failures of internal controls at a number of U.S. companies. Investor confidence in the U.S. public markets was shattered, and SOX was a necessary and appropriate response to a market crisis.

As a leading voice for long-term, patient capital, the Council believes the Sarbanes-Oxley Act has been vitally important in restoring confidence in and integrity to the financial markets, strengthening investor protections and increasing the accountability of corporate executives and directors of companies of all sizes.

The Council continues to wholeheartedly support the underlying intent of the Sarbanes-Oxley Act, particularly Section 404, for all public companies, large and small. As detailed in the following responses to the questions raised by the Committee's release, the Council strongly believes that the Sarbanes-Oxley Act, including Section 404, should remain intact in its entirety for large and small companies.

Any company, large or small, seeking capital in the U.S. from the investing public must be held to the highest possible standards for accounting integrity, disclosure and transparency. These most basic standards—which are applicable to all publicly traded companies, regardless of size—are why the U.S. capital markets are the envy of the world.

The Council urges the Committee to proceed cautiously with any considerations to "water-down" SOX for small companies. Imposing requirements differentiated by company size—whether pertaining to accounting standards, audit standards, disclosure requirements and/or basic governance requirements—is bad public policy, confusing for the investing public and, in the long run, a bad business decision. Such a shift is a slippery slope that the Council fears could ultimately seriously harm the capital markets and the investing public.

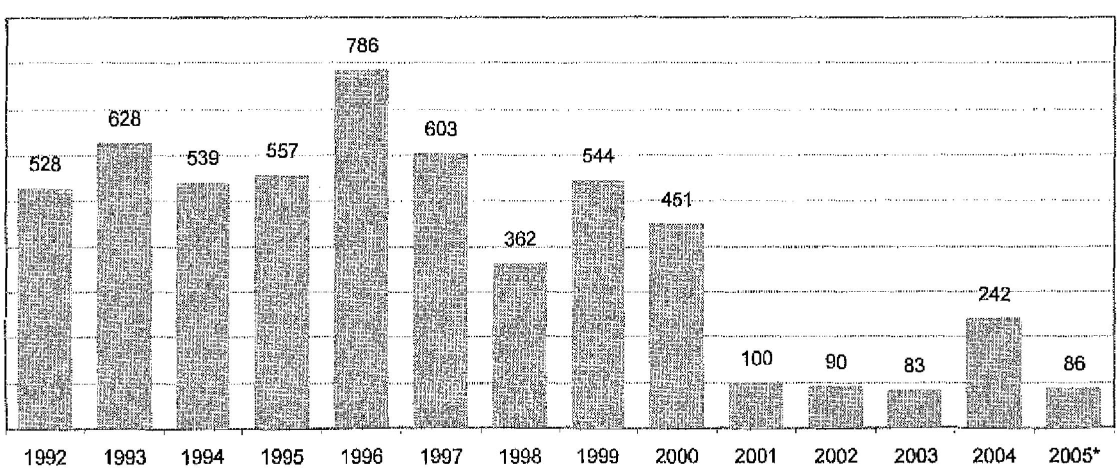
General Impact of Sarbanes-Oxley Act on Smaller Companies

As long-term owners of U.S. public companies, Council members agree that rules and regulations imposed on companies should not be burdensome or unnecessary. The Council does not believe the Sarbanes-Oxley Act falls into these categories.

The Act has not diminished the value of smaller companies or decreased the attractiveness of the U.S. capital markets. Indeed, the Council believes it has enhanced both and played a crucial role in rebuilding confidence in the U.S. markets. That confidence supports the development of small business by making capital available at reasonable costs, which is a benefit that should not be overlooked in this process.

No statistic better addresses the Committee's questions regarding the impact on entrepreneurship and the ability/willingness of companies to meet the demands of being public, than the recent experience of initial public offerings. It is painfully clear that the damage to the capital markets from the fraudulent behavior that became public beginning in 2001 dramatically lowered the access to capital for small companies. It is equally clear that the positive impacts of the reforms such as SOX have helped restore access to capital and increase the ability to issue IPOs. This evidence suggests that the regulatory reforms have not damaged entrepreneurship or changed company thinking about going public. Rather, the reforms have helped reopen the opportunity for small companies to access efficient and fairly priced capital markets.

Chart 1: Total Number of IPOs



Source: Nasdaq, IPO Monitor. * Through June 30, 2005.

Companies have also cited a range of important benefits from the Act, including improved "tone at the top," more involved boards of directors, more robust audits by external auditors, enhanced internal audit resources and performance, higher quality financial statements, fewer restatements of financials and improved operational efficiency. These changes are long-term in nature and difficult to quantify, but the Council believes these benefits over time will far outweigh the costs and will be a positive for all involved in the U.S. capital markets.

William R. Brown, executive VP and CFO of Plum Creek Timber, summarized these benefits in his March 23, 2005, comment letter to the SEC: "As a result of Sarbanes-Oxley and SEC regulations, the intent of Congress to strengthen financial reporting credibility is being achieved. The management of public companies are more aware of their financial reporting responsibilities, and investors have a higher degree of confidence in the documents they produce. In the long-term, that's good for U.S. businesses and investors in the American capital markets."

His statement goes to the heart of the recurring theme of the Advisory committee's questions regarding the impact and effectiveness of the Act and whether smaller companies should be subject to different standards. We agree with Mr. Brown's comment that SOX is in the best long-term interests of the capital markets, and as a result, we oppose efforts to dilute SOX provisions for small or large companies.

Clearly, the implementation costs of portions of SOX have been higher than anticipated. However, first-year implementation problems are not sufficient reason to weaken or eliminate SOX requirements or to adopt significant exemptions based on company size. This action would be premature and would risk serious damage to important reforms that have helped rebuild confidence in the U.S. capital markets. It is simply too early to fully measure SOX's ongoing costs (which are far more important than the implementation costs) and perform a complete cost-benefit analysis. This is not to suggest that investors will tolerate unnecessary costs or gouging by audit firms related to internal control certification.

As discussed earlier, many of the benefits to investors of SOX are long-term and also more intangible than the hard dollar costs of implementation that can be readily identified. The market capitalization of the two major exchanges in the U.S. has increased by about 50 percent or $5.8 trillion since the end of 2002[1]. It is plausible to assume that a major portion of this value can be attributed to improved investor confidence resulting from the major reforms such as SOX. In light of the magnitude of the increased value of the U.S. capital market, the projected ongoing costs appear reasonable. As owners of the companies, investors are the most credible source for a balanced, long-term assessment of the cost/benefit trade-offs of the reforms.

<u>SOX Section 404/Internal Controls</u>
The Council believes Section 404 is a cornerstone of SOX and a necessary adjunct to Section 302, which requires CEOs and CFOs to certify that the annual and quarterly financial reports fairly represent the financial condition and operating results of the companies and to acknowledge that they are establishing and maintaining internal controls.

[1] Source, NYSE and NASDAQ

In this section of the Request for Public Input, the Committee seems interested in feedback on whether small companies are particularly disadvantaged by SOX 404 requirements and whether it is advisable to lower the standards for smaller companies. The Council is concerned that this line of questioning and underlying reasoning leads to consideration of concepts that could be characterized as "404 light" and "GAAP light" for small companies. The Council does not support these concepts and believes that, generally, small companies must be held to the same standards as all other public companies.

Smaller companies already face challenges with access to capital, analyst coverage and even investor interest due at least in part to their perceived increased risks. Setting lower standards for internal controls, regulatory oversight or accounting standards may only make this problem worse.

Internal control problems and scandals are not isolated to larger companies. In fact smaller public companies are more likely to have problems related to internal controls than their larger brethren, so Section 404 is very relevant to small companies. A recent letter from Dana R. Hermanson, professor of accounting at Kennesaw State University, published in *The Wall Street Journal* noted that "it also is critical to recognize that smaller public companies historically have accounted for the vast majority of accounting fraud cases brought by the U.S. Securities and Exchange Commission. In my research on accounting fraud, the typical fraud company was quite small and exhibited signs of an inadequate board and audit committee. In addition, we often found evidence of management override of internal controls, as the vast majority of frauds apparently went to the top of the organization." It would be irrational for the SEC to lower investor protection related to key regulatory reforms such as 404 in precisely the area of the market where the largest number of internal control failures occur.

The Public Accounting Oversight Board's Accounting Statement 2 is designed to be flexible and accommodate differences between large and small companies. It appropriately recognizes that reviews should not be a checklist or a one-size fits all exercise; it appropriately requires auditors to exercise professional judgment; and it appropriately gives auditors the discretion to rely on the work of others. It does not require testing of all controls—only those that might make it probable that the financial statements are materially wrong. As a result, smaller and presumably less complicated companies should incur proportionately lower costs for 404 compliance.

Some of the 404 implementation outlays can be attributed to expected one-time start-up costs associated with complying with <u>any</u> new regulatory standard. The Council believes that most of the criticized costs of compliance with 404 are one-time expenditures caused by years of corporate neglect of internal controls. Complaints over the alleged burdensome and onerous costs of Section 404 are powerful evidence that companies have failed to remain in compliance with the Foreign Corrupt Practices Act of 1977. Former SEC Chairman William Donaldson put it correctly in a March 29, 2005, *Wall Street Journal* article, stating "...Section 404 reporting is too important not to get right. The resources now being devoted to Section 404 will, in the long run, prove to be money well spent."

Some 404-related costs may also be attributed to inappropriate and/or overly conservative interpretations of PCAOB Auditing Standard No. 2. Implementation problems, inefficiencies and overkill are not in the best interests of companies or their investors, and we urge the Securities and Exchange Commission, the Public Company Accounting Oversight Board and COSO (the Committee of Sponsoring Organizations of the Treadway Commission) to continue to provide guidance to address these problems. Special guidance—particularly in the areas of scope of the 404 review and reliance on the work of others—for smaller public companies could be one constructive way to assist efforts to reduce the cost of implementing Section 404 and address concerns that 404 is disproportionately burdening small/mid-sized firms.

Enhanced efficiencies should reduce the costs of compliance going forward. This assertion is supported by expert opinion, studies and even predictions from leaders in the audit industry stating that 404-related costs will decline by as much as 40 percent in subsequent years. Softening the rules for smaller public companies now based mostly on first-year implementation costs would be like estimating all future gas usage of a car based on driving up a steep hill.

Finally, it is important to emphasize that shareowners are not complaining about the costs of Section 404. Since effective internal controls are at the core of reliable financial reporting, shareowners—who ultimately pay 404-related costs—are more than willing to see a company spend money to ensure that the controls are appropriate and effective. Investor support of this important provision of the Sarbanes-Oxley Act is not surprising considering the tremendous losses investors have suffered and continue to suffer as the result of internal control failures and accounting scandals at a host of companies, including small and large firms alike.

Investors are willing to shoulder a reasonable level of additional costs to enjoy section 404's expected longer-term benefits—including stronger internal controls, more reliable financial statements improved confidence in the quality of reported financial statements and improved operational efficiencies. In the long run, small companies that invest in appropriate internal controls are not only more likely to have more reliable financial statements, but also will benefit from better management information structures. It is logical to assume that better information will lead to greater operational efficiency and better long-term performance.

Corporate Governance/Listing Standards

Changes to the NYSE and Nasdaq listing standards requiring a majority of independent directors and all-independent audit, compensation and nomination committees essentially mandated governance standards that have long been observed by many U.S. companies. The changes may have been dramatic to corporate governance laggards, but they were hardly groundbreaking to the many companies already embracing good governance practices.

Most of the changes addressed outdated listing standards that had been in place for decades. The Council urges the Committee to recommend that the exchanges maintain processes to ensure that listing standards are "living documents" updated on a consistent, ongoing basis, rather than sporadically in response to periodic market crises.

Listing standards cannot prevent corporate fraud, deter criminals or ensure ethical behavior. But they can at least ensure that corporate boards have formal structures and processes in place to do the best job possible for investors. As a result, the Council believes the minimal listing standards required by the exchanges should be expected of any company, large or small, accessing the public markets.

There is no evidence that that these basic standards are creating a hardship for smaller companies and certainly no reason to believe that the benefits of maintaining independence on key committees are outweighed by costs. Indeed, isn't an independent board of directors as representatives of shareholders a key tenet of the governance system in the United States? Similar to the points above, the Council believes that lower standards for smaller companies are a disservice to investors and companies alike.

Conclusion

The Council thanks you for your support in facilitating a dialogue on how smaller public companies are impacted by the Sarbanes-Oxley Act and Section 404 in particular. If you have any questions or comments please feel free to contact me, Ted White or Alyssa Ellsworth at (202) 822-0800.

Sincerely,

Ann Yerger
Executive Director
Council of Institutional Investors