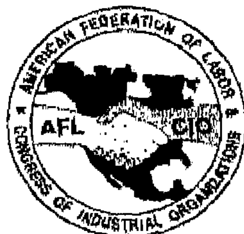
American Federation of Labor and Congress of Industrial Organizations



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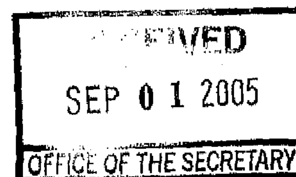
August 31, 2005

VIA FACSIMILE (202) 772-9324



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

Re: File Number 265-23

Dear Mr. Katz:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to provide input to the Securities and Exchange Commission ("SEC") Advisory Committee on Smaller Public Companies ("Committee") regarding the current regulatory system, including the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOX").

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets, and union members also participate in the capital markets as individual shareholders. In particular, union members' pension funds are broadly invested in a variety of small-cap index funds and are sizable shareholders in many small public companies.

The AFL-CIO strongly supports the crucial safeguards found within SOX, including Section 404's internal controls requirement. In our view, full compliance with SOX is a necessary precondition for any company, regardless of its size, seeking to access the U.S. public equity markets. Furthermore, we note that Section 404 of the Sarbanes-Oxley Act applies to all public companies under the Securities and Exchange Act. Consequently, the Commission does not have the authority to exempt by regulation certain public companies from the requirements of Section 404.

The AFL-CIO is keenly aware of the important role that smaller public companies play as engines of job creation and economic growth. However, companies that cannot for reasons of scale afford either to have adequate internal controls or obtain an independent audit of those controls should seek financing in the private markets, where investors typically have an independent capacity to assess such issues. This is no different than companies that cannot afford an independent financial audit or the legal costs associated with Regulation S-K. In particular, we believe strongly that it should not be possible for a broker to call a union member at home and ask them to buy securities of a company that cannot obtain independent confirmation that they have adequate financial controls.

However, the AFL-CIO is supportive of giving non-accelerated filer companies longer deadlines to comply with Section 404. We believe this more relaxed time frame is the appropriate response to the costs that have been associated with Section 404 compliance at accelerated filers. It has become clear that there is a balance that must be struck between issuers and public company auditors to ensure that Section 404 compliance occurs in a cost effective and thorough manner. In general, we believe that the Commission and the PCAOB have managed the issues surrounding Section 404 in a thoughtful and balanced manner, and commend both.

The Committee asked for responses to a series of questions regarding the general impact of the Sarbanes-Oxley Act. The following discussion represents the AFL-CIO's response to the Committee's questions, and where appropriate will indicate when a response is offered to a specific question.

A. SOX and Small Business

The safeguards and regulatory framework found in SOX should apply equally to public companies regardless of size, as a condition of their desire for public investment. Complete and accurate financial reporting, along with adequate internal controls that provide reasonable assurances that financial statements have been adequately prepared, are crucial requirements for any publicly listed company.

Research on accounting fraud demonstrates that small companies are at greater risk for compliance breakdowns. Kennesaw State University Accounting Professor Dana Hermanson has found that "the typical fraud company was quite small and exhibited signs of an inadequate board and audit committee." He also "often found evidence of management override of internal controls, as the vast majority of frauds apparently went to the top of the organization."[1] Proxy voting advisor Glass Lewis and Company reports that smaller public companies restate twice as often as large public companies. Specifically, "companies with annual revenues of less than $500 million had a 2004 restatement rate of 9%. Companies with revenues of more than $10 billion had a 2004 restatement rate of less than 4%.[2] Of the 738 companies that reported material weaknesses in 2004 and 2005, 56% were companies with under $200 million in market

[1] *SOX and Small Business*, Letter to the Editor, *Wall Street Journal*, August 19, 2005
[2] *Restatements – Traversing Shaky Ground*, Glass Lewis & Co., June 2, 2005

capitalization, including 168 with under $25 million in market value. Given these serious accounting weaknesses in smaller public companies, SOX is a crucial investor protection statute.

The effective internal controls ensured by Section 404 are the backbone of high quality financial statements, and the Committee should keep in mind the failure of internal controls that contributed to the accounting scandals of the past few years. The initial implementation costs of Section 404 are in many ways correcting the effects of deferred maintenance and bringing controls up to the standard securities laws always required. Companies have been required since the Foreign Corrupt Practice Act of 1977 to maintain systems of internal controls for transactions and records, and complaints about Section 404's burdensome costs offers powerful evidence that companies failed to comply with the 1977 act. Lastly, compliance costs associated with Section 404 are expected to decline over time. Survey responses by audit firms suggest that total 2005 client compliance costs, including Section 404 audit fees, will be 46% less than the estimated 2004 costs.[3]

One of the Committee's questions asks whether "the benefits of SOX Section 404 outweigh its costs for smaller companies?" While it is impossible for shareowners, who pay the costs of audits, internal controls and financial fraud, to explicitly quantify the benefits of Section 404, the non-quantifiable benefits are enormous. Adopted in the midst of a systemic crisis in investor confidence following the collapse of Enron and Worldcom, Sarbanes-Oxley and Section 404 almost single-handedly prevented a total market collapse. As Section 404 and Sarbanes-Oxley become more ingrained in the corporate culture, additional benefits will likely include fewer restatements, fewer SEC financial reporting cases, and fewer successful private actions involving accounting fraud. From the standpoint of institutional investors and the millions of individual investors represented by the AFL-CIO, the benefits of more reliable financial statements and improved confidence in the quality of financial statements far outweigh the criticized costs of the rule. We believe that 404 compliance is relatively cheap way to manage the risk both of further large-scale collapses such as Enron and WorldCom and the incidence of smaller scale events at multiple smaller companies.

B. Smaller Public Companies and Board Independence

The AFL-CIO notes with particular concern the Advisory Committee's focus on the perceived "hardship" for smaller public companies as a result of the independent director listing standards of the New York Stock Exchange ("NYSE") and others. Because of their small size and greater numbers, individual small-cap companies inherently receive less corporate governance scrutiny from institutional investors, the business media, and securities regulators than their larger counterparts. Given the higher incidence of restatements and accounting fraud at smaller public companies, coupled with the prevalence of inadequate board and audit committees in fraud companies, the oversight role of independent boards is even more important as they fulfill their fiduciary duty to act in the best interest of shareholders.

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C. The Advisory Committee's Recent Recommendations

The Advisory Committee recently submitted two resolutions on August 18, 2005, while the comment period was still open. The timing of this action was inappropriate and gives the impression that the Advisory Committee is uninterested in the public comments it is soliciting. One Committee resolution proposed extending the dates for non-accelerated filers to comply with the filing requirements of Section 404 of SOX to July 15, 2007, instead of July 15, 2006. The AFL-CIO supported the first Section 404 compliance extension for non-accelerated filers, and while we do not object to this recommendation for a further extension, we would strongly oppose any further extensions following the July 15, 2007, deadline.

The Advisory Committee's discussion of smaller public companies in its two most recent releases is not terribly helpful. As regards Section 404, the focus of this discussion should be limited to non-accelerated filers, and any effort to give more latitude to other companies would lead to a serious weakening of Sarbanes-Oxley and the securities law framework. It is unclear what uses the Committee proposes to make of its broader definition of "smaller companies," and it is also unclear whether the Committee has settled on a definition. An earlier request for comment noted "you should not assume that there is a set cut-off in size of smaller companies in responding to the Advisory Committee's request."[6] In the August 10, 2005, release, however, smaller public companies were defined as those with a market capitalization of less than $700 million.

The Advisory Committee's second resolution recommended that "smaller public companies not be subject to any further acceleration of due dates for annual and quarterly reports under the 1934 Act."[7] We are concerned, however, about the impact as it relates to investors in small companies. Time sensitive information has a far greater impact on smaller public companies given their narrower product, employee and infrastructure base. By allowing important greater delays for routine disclosure, insiders are given the opportunity to trade on non-public knowledge and the likelihood the information

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selectively leaks to certain investors is increased. While the bases for the resolution are valid, they should be weighed against these issues, and there is no sign in the Committee's cursory release that these issues were considered.

D. Conclusion

When it comes to protecting U.S. investors, there is simply no justification for a substantive double standard based on company size. Companies that cannot meet the minimum standards necessary for protecting public investors should look to private markets for financing.

Of course, SOX has its critics, like Hank Greenberg, the former Chairman and CEO of AIG, who labeled some of the SEC's new regulations as "foolishness" and characterized Sarbanes-Oxley as a costly excess. But these voices are not representative of mainstream investor or business opinion. A 2004 Oversight Systems Report on Sarbanes-Oxley found that 74% of respondents say their company benefits from SOX compliance. 75% also said they would vote to keep Section 404 if they were members of Congress. Almost a third of this survey group included executives from companies with revenues of $250 million or less.[8] Donald Nicolaisen, the SEC's chief accountant has also rightly pointed out "our capital markets run on faith and trust. Being able to report that a company has in place strong internal controls strengthens public confidence. If that's the case, I think it's worth the cost."

We appreciate the opportunity to present our views on this important matter. If we can be of further assistance please do not hesitate to contact me at 202-637-3953.

Sincerely,

Damon Silvers
Associate General Counsel

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel Campos
Commissioner Cynthia A. Glassman
Commissioner Annette L. Nazareth
Chairman William J. McDonough

[8] *Section 404 of the Sarbanes-Oxley Act: Survey Extracts*, March 2004-March 2005. Compiled by Deloitte & Touche, Ernst & Young, KPMG and PriceWaterhouseCoopers.

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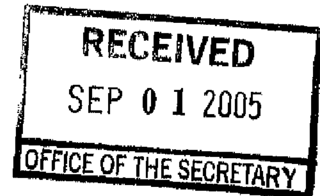

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