American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000
www.aflcio.org

March 27, 2006

Via electronic mail to rule-comments@sec.gov

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:

On February 21, the Small Business Advisory Committee ("Committee") established by the Securities and Exchange Commission ("SEC") formally presented recommendations that if acted upon would seriously undermine the Sarbanes-Oxley Act of 2002. The Committee has recommend unlawfully exempting public companies from the internal controls provisions of Sarbanes-Oxley and unlawfully weakening the definition of an audit of internal controls for others.

The Committee's recommendations are at odds with the general approach to SOX enforcement that the SEC and the Public Company Accounting Oversight Board have taken under the leadership of Chairman Cox and Acting Chairman Gradison, and that of their predecessors. The AFL-CIO urges the Commission and the PCAOB to ignore the Committee's specific recommendations and instead to continue to work with auditors and issuers to rationally manage the process of complying with the Sarbanes-Oxley Act.

The AFL-CIO strongly opposes weakening Sarbanes-Oxley's crucial safeguards for the companies most likely to have internal control problems and be engaged in defrauding investors.[1] Union members participate in benefit plans with over $5 trillion in

[1] According to former SEC Chairman Arthur Levitt ("A Misguided Exemption," 1/27/2006, *Wall Street Journal*), "[i]n the five years before 2004, nearly three-quarters of financial restatements were reported by companies with annual revenues of less than $500 million." Kennesaw State University Accounting Professor Dana Hermanson has found that "the typical fraud company was quite small and exhibited signs

assets. Union-sponsored pension plans hold approximately $400 billion in assets. Workers' pension funds are broadly invested in a variety of small-cap index funds and are sizable shareholders in many small public companies. Most importantly for this issue, union members participate in the capital markets as individual shareholders and like other investors are frequently asked by brokers to consider investing in small or micro cap companies. We believe it is irresponsible to allow companies without effective internal controls to sell securities to our members and the investing public.

The Committee's recommendations would exempt a large percentage, perhaps as high as 80% of all public companies, from having to provide investors with transparency with respect to the effectiveness of their internal controls. Companies with a market cap of less than $128 million and revenue of no more than $125 million would be exempt completely from 404 requirements. Slightly larger companies, with a market cap of less than $787 million and annual revenues between $10 million and $250 million, would not be required to undergo a genuine audit in which an independent, outside auditor tests internal controls.

The Small Business Advisory Committee's recommendations are particularly irresponsible because the Sarbanes-Oxley Act explicitly requires all public companies to attest to the adequacy of their internal controls and to obtain an outside audit of their attestation. The Sarbanes-Oxley Act provides an explicit exemption for investment companies and no further exemptions. Consequently, neither the Commission nor the PCAOB have the authority to either exempt public companies from complying with these internal controls provisions or from obtaining a genuine audit of their attestation.

Indeed, a recent letter from Professor James Cox of Duke University and a group of distinguished law professors noted "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." A copy of this letter is attached for your review. Kurt Schacht, the sole investor representative on the Committee, also addressed this issue in his dissent from the recommendations.

We urge the Commission and the Board to preserve Sarbanes-Oxley and its ability to protect small public company investors. Any exemption, whether in whole or in part, from the internal controls provisions of the Sarbanes-Oxley Act would send the wrong signal to investors and weaken the benefits of stronger controls for the companies most in need of them.

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.

---

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."

Sincerely,

Damon Silvers
Associate General Counsel

Enclosure

DUKE LAW

Duke University School of Law
Box 90360
Durham, North Carolina 27708

James D. Cox
Brainerd Currie Professor of Law

Telephone (919) 613-7056
Facsimile (919) 668-0995
E-mail: cox@law.duke.edu

March 21, 2006

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

Re: Response to SEC Release 33-8666 Seeking Comments on the Exposure Draft of the Final Report of the Advisory Committee on Small Business

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 <u>of this title</u> 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, Commisssioner
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 Thel
Wormser Professor of Law
Fordham Law School

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