February 13, 2006

Mr. Christopher Cox, Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Mr. William Gradison, Acting Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

Dear Chairman Cox and Acting Chairman Gradison:

We strongly recommend the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) not accept the recommendation of the Small Business Advisory Committee that would remove an estimated 80% of all public companies from the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes Oxley).

Such a recommendation simply goes too far. When new accounting and corporate fraud scandals develop, as they surely will, people will ask who was responsible for a policy decision resulting in such sweeping exemptions. It would rank with the accounting profession’s 3% rule on SPE’s and the famous Garn/St. Germain legislation in the early 1980’s that led to the failure of hundreds of savings and loan (S&L) institutions when restrictions on their lending activities were suddenly swept away. The S&L industry recommended that legislation to solve a problem, but the disaster that followed in a few years cost the American taxpayers about $250 billion. In passing the Sarbanes Oxley legislation, the Congress adopted a reasonable approach to achieve real reform, not just the appearance of reform. It would be unfortunate now if the SEC and PCAOB undercut the effectiveness of Congressional legislation through misguided regulatory action.

A much more reasonable approach to assist the small public companies and to protect investors was outlined by the former Chairman of the SEC, Arthur Levitt’s recent Op-Ed piece in the Wall Street Journal which is enclosed as an attachment to this letter.

The five signatures below are the individuals that comprised a sub-committee for the audit and accounting section of the 2003 Conference Board Commission on Public Trust and Private Enterprise report that was convened to address the circumstances which led to the 2002 corporate scandals and subsequent decline of confidence in American capital markets.

Sincerely,

John H. Biggs
Former Chairman and CEO of TIAA-CREF

John C. Bogle
Former Chairman of Vanguard Group, Inc.

Charles A. Bowsher
General of The United States of America

Arthur Levitt, Jr.
Former Chairman of the SEC

Paul Volcker
Former Chairman of the Board of Governors of The Federal Reserve System

Attachment
A Misguided Exemption
By ARTHUR LEVITT, JR
January 27, 2006; Page A8

I began my Wall Street career more than 40 years ago sharing an 800-square-foot office with 10 other brokers. Since then, I have been involved in a number of small businesses—from newspapers to high-tech companies—and no matter the industry, the focus of every one of these has been growth. Unlike in a large company, stagnancy in a small business can lead not only to a diminished paycheck, but to extinction.

Small businesses employ a majority of private-sector workers and create 60% to 80% of net new jobs annually. This economic might, combined with the sector's political muscle, has kept policymakers vigilant in spotting impediments to small-business growth. Currently, the focus of many small-business advocates is the perceived burden placed on them by Section 404 of the Sarbanes-Oxley Act, which requires companies to assess and report the status of their internal controls. They worry that the cost of compliance is onerous, inhibiting their ability to access capital markets and grow.

In response, the Securities and Exchange Commission's advisory committee on smaller public companies has recommended that microcap and smaller public companies be exempted from the main parts of 404. Under their plan, public companies with a market cap of less than $100 million and revenue of no more than $125 million would be exempt completely from 404 requirements. Slightly larger companies—those with a market cap of less than $700 million and revenues of no more than $250 million—would not be required to have an independent, outside auditor test their internal controls.

While the advisory committee is well-intentioned, I fear that these proposed changes will harm, not help, small companies. I can appreciate the political pressure the SEC may be facing; the small-business lobby is almost unrivaled in the fear it instills in policymakers. But political pressure often leads people down the path of least resistance and toward superficial, even counterproductive, fixes. Indeed, if these recommendations were implemented, they would make it more difficult for smaller companies to attract capital needed for growth and undermine confidence in the markets. Instead of searching for exemptions to the rule, we need to step back and help small businesses improve financial controls, attract capital, and strengthen the very markets critical to their ability to flourish.

Thankfully, the market downturn of the immediate post-Enron years is behind us. As seen in the significant increases in IPO and mergers-and-acquisitions activity, there is a renewed vigor in our markets. Driving this has been a resurgence in investor confidence, fueled by the implementation of SOX reforms, including those enumerated in Section 404.
Exempting smaller and microcap companies -- 80% of all public companies -- from the requirements of 404 would undermine this renewed trust in our markets. Consider that these companies are the ones most likely to have internal control problems, and least likely to have analysts, institutional investors and the media watching them. In the five years before 2004, nearly three-quarters of financial restatements were reported by companies with annual revenues of less than $500 million. Already, many institutional investors do not invest in smaller companies because of risks associated with them. If one increases that risk by setting a lower bar for internal controls, it will burden these companies with a risk premium that will drive up their cost of capital. Creating a different standard would relegate small businesses to a "second-class" in the marketplace, and hinder their growth as much as any onerous regulation.

The debate until now has centered on who should be exempted, not on how to ensure that companies have the internal controls needed to prepare reliable financial statements. This focus is unproductive since it is clear from a reading of SOX that Congress wanted all public companies to assess internal controls and have an outside auditor test them. Instead of defying Congress and provoking costly litigation, we need to work within the law to find ways to make compliance easier and less expensive for small businesses.

To start, we need to recognize the difficulties in compliance that turned up in the first year of 404-compliance. Many companies were ill-prepared for an audit: Their internal controls either were not in place or not documented, and many lacked accounting and finance staff able to do this work. At the same time, many of the audit firms lacked the tools, expertise and training to assess the internal controls of smaller companies. They were using audit tools created for large multinationals, the financial equivalent of using an MRI to diagnose a cold. Many audit firms failed to integrate their findings from the internal control testing into the financial statement, as required by SOX, and as a result performed two separate audits. As the SEC and Public Company Accounting Oversight Board have noted, auditing firms needlessly repeated management and internal auditors' tests of internal controls, creating more work for themselves and higher bills for small businesses.

- Moving forward, we need, first, to redefine what constitutes a small business. The current debate has been skewed by a definition so broad as to include a vast majority of the market. A company's complexity is not dependent on its market cap. Some very large companies -- such as many of the airlines -- have market caps that pale in comparison to their complexity. Conversely, there are tech companies that have few employees and office sites, but huge market caps based on expected revenues. The current definition of a small business issuer should be updated to include companies with up to $50 million in revenues and fewer than 250 employees. If they have been able to attract more than $100 million in public capital, they should be ineligible for small business filer status.

- Second, the SEC and PCAOB should urge accounting and financial executive trade groups, as well as the software industry, to work together to develop reasonably priced tools tailored specifically for small companies and the small accounting firms who mainly audit them. These should permit a company to document internal controls so that auditors do not need to duplicate the documentation, and include control testing programs
integrated with that documentation and the work performed on the year-end balance sheet and income statement. The tools must be made available before 2007 when small companies are required to comply with 404.

- Third, the SEC must reconfigure itself to provide more readily accessible assistance to small companies. In 1997, I reorganized the SEC so that the enforcement function was centralized in Washington. An unintended consequences of this was to close off a local avenue for accounting assistance for small businesses. Many small companies do not have good technical accountants and cannot afford them. If the SEC placed those that review small business filings closer to the businesses and supplemented its staff with a small group of accountants that can answer questions small companies might have, it would help avoid restatements and reduce costs.

- Fourth, while the SEC and PCAOB have issued some helpful guidance on how to streamline the auditing of internal controls, they should go further in easing requirements while stepping up enforcement. If a company has documented monitoring controls, and the monitoring process has not discovered any problems except for isolated cases, then no further internal examination by the company should be required. Re-examining controls when monitoring controls are working has layered on unnecessary work that has driven up costs for businesses. Companies should be given credit for doing the right thing, and not have to pay to recheck what they are doing right. However, if the auditor finds that monitoring controls have not been working and financials need to be restated, then a company should expect a swift SEC enforcement action.

These steps should help small companies update internal controls cost-effectively, without gutting the financial reporting regime that undergirds our capital markets. In light of the importance of small businesses to the economy, the last thing we need is regulation that stifles their entrepreneurship -- or deregulation that makes it more difficult for them to succeed in the public capital markets.

*Mr. Levitt, former chairman of the SEC, was the chairman of the first White House Conference on Small Business.*