Next Steps for Section 404: A Tale of Two Statutes

There is a fascinating parallel between the two major U.S. laws enacted in this century affecting businesses: the Sarbanes-Oxley Act ("Sarbanes-Oxley") and Title III of the USA PATRIOT Act ("Patriot Act"). Both statutes were enacted in response to national crisis, both were enacted with relatively limited Congressional debate, both were adopted overwhelmingly, both have required affected companies to devote substantial financial and personnel resources to compliance, and both have contributed to foreign concern about the imperialism of the U.S. legal system.

There is one other parallel that goes directly to the topic of our panel this afternoon: Section 404 of Sarbanes-Oxley – Next Steps. In both cases, the most serious burden for affected companies is not the cost of implementation -- high though that is. Rather, it is the risk of an unrealistic oversight and enforcement process that places institutions in undue jeopardy and discourages rational, in favor of defensive, compliance policies.

There is little appetite for reopening either statute to seek to modify the provisions that are deemed excessive. Nor is it reasonable to ask the regulators to take interpretative positions that would arguably undercut the intent of Congress.

What is reasonable, however, is to ask the regulators to adopt a consistent oversight and enforcement approach that is sufficiently realistic to take into account the circumstances in which compliance is evaluated. The following is a list of ten important factors relating to oversight and enforcement of Section 404 (and which could, in large part, also relate to other provisions of Sarbanes-Oxley and to the Patriot Act).

- For everyone – regulators, corporations, accountants and investors -- the statute and regulations are new, broad and in some cases unclear. Indeed, accountants and companies are having to cope with arguably the most significant new auditing standard to be issued in years. It will take some time for companies and accountants to understand what they are entitled to expect of each other and what the SEC and PCAOB are entitled to expect of both of them.

- If the standards for material weakness and significant deficiency are set too low, or are not truly risk-based, the product -- public disclosure that provides meaningful information to investors -- will be cheapened. Disclosure of truly significant internal controls issues would be lost in the sea of less significant issues. (The parallel exists here to concern about excessive "defensive" Suspicious Activity Report ("SAR") filings under the Patriot Act.)

- The carefully drawn distinction between public disclosure of "material weaknesses" and the non-public nature of "significant deficiencies" should not be undermined by an oversight and enforcement policy that "encourages" public disclosure of significant deficiencies.

- Similarly, this distinction should not be undermined by an oversight and enforcement policy that second-guesses auditors' and managements' categorization of a controls issue as a significant deficiency rather than as a material weakness.

- Material weaknesses do not automatically equate to doubt about the validity of an issuer's financial statements. The broad definition of material weakness should make it more of an early warning system than a finding of a serious problem. The

SEC's public communications should preserve this distinction and encourage investors not to overact to material weakness disclosures.

- Section 404 compliance is administered by people. People make mistakes, particularly on novel issues and issues that involve subjective judgment, such as whether a particular internal control issue is a "material weakness", a "significant deficiency" or just a deficiency. Mistakes should not equate to an offense that requires sanction. If mistakes are punished unduly, good decisions will not get made. The PCAOB inspection process for auditing firms should appropriately recognize this concern.

- During this critical early implementation period, the SEC and PCAOB can facilitate a constructive atmosphere -- as opposed to an adversarial one -- by creating a process for responding to questions of issuers and auditors about implementation of the new auditing standards similar to the Emerging Issues Task Force for Accounting Standards.

- The period required for sufficient understanding will take longer for foreign private issuers (which the SEC has already recognized in extending the compliance deadline).

- Even superior internal controls systems will not always detect fraud. The person committing the fraud will be dedicated to defeating the system, and there is no controls system that is designed to examine the minds and hearts of all the company employees who are involved.

- It is widely, but not universally, anticipated by both government officials and the private sector that the financial burden of Section 404 will decline significantly in the second year. Absent, however, a concerted effort to deal with the issues that have emerged during this first year (such as over-emphasis on technology issues), the level of

cost reduction may be disappointingly low. If the financial burden remains unduly high because legitimate issues are not addressed, the critical balance between benefit and burden will be undone. This Roundtable is a valuable first step in dealing with the key issues.

None of these points is designed to be a call for a "kinder and gentler" SEC. There have been too many serious betrayals of shareholders and debtholders, and, more broadly, there has been a betrayal of the public trust. Although actions against individual malefactors may serve to deal with the former, new processes and procedures , such as Section 404, are required to deal with the latter. There is, however, a need for an oversight and enforcement policy that recognizes the realities of compliance with a sweeping new regulatory program, that recognizes that mistakes and errors will be made, and that distinguishes between mistakes and errors, on the one hand, and purposeful dereliction and malfeasance, on the other hand.

There is substantial resilience among the corporations subject to our securities laws, combined with their genuine, widespread and, indeed, self-interested desire to promote transparency and deal aggressively with those who abuse these laws. It is essential that this resilience and intent not be compromised by an oversight and enforcement program that requires corporations and their accountants to act defensively rather than progressively. In the final analysis, a partnership between the government and business will be more successful than confrontation in achieving legitimate societal objectives for corporate finance.