OPERS Ohio Public Employees Retirement System
277 East Town Street Columbus, Ohio 43215-4642 1-800-222-PERS (7377) www.opers.org

August 31, 2005

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

Re: File Number 265-23 – SEC Advisory Committee on Smaller Public Companies

Dear Mr. Katz:

The Ohio Public Employees Retirement System ("OPERS") is a more than $64.5 billion fund serving three quarters of a million Ohioans, making the system the 10th largest state pension fund in the U.S. We appreciate the opportunity to provide input to the SEC Advisory Committee on Smaller Public Companies ("Committee"). OPERS' responses to the questions posed by the Committee follow this letter.

Should you need any additional information, please contact Cynthia Richson, OPERS Corporate Governance Officer, at 614.222.0398. Thank you for your consideration.

Sincerely,

Laurie Fiori Hacking

Laurie Fiori Hacking
Executive Director

1. Has SOX changed the thinking of smaller companies about becoming or remaining a public company? If so, how?

SOX does not appear to have changed smaller companies thinking about becoming or remaining public. Since the wave of accounting scandals that began with Enron and continued with WorldCom, Adelphia, Tyco, AIG and others, the thinking of all companies has changed. The enactment of the Sarbanes-Oxley Act of 2002[1] ("SOX") has contributed significantly to restoring investor and public confidence in the U.S. financial markets.

One of the main reasons for a company to go public is to gain access to investment capital in the public capital markets. In 2004, there were 242 initial public offerings ("IPOs"), which almost equaled the total from 2001, 2002 and 2003 combined[2], and as of June 30, 2005 there have been 86 IPOs.[3] These numbers indicate that SOX has not discouraged companies from going public. Moreover, when a company raises funds from the public, that company assumes an obligation of public trust and accountability necessary to protect the public interest. It is key to the capital formation process that investors who fund new companies be treated fairly and be given reasonable information about the business in which they invest.

2. Has SOX affected the relationship of smaller companies with their shareholders? If so, how?

SOX appears to be having a positive affect on the relationship of smaller companies with their shareholders by causing more reliable financial reporting and greater investor confidence. In fact, a study of U.S. markets by Paul Gompers and Joy Ishii of Harvard University and Andrew Metrick of The Wharton School found that portfolios of companies with strong shareowner rights protections outperformed portfolios of companies with weaker shareholder protections by 8.5% per year.[4] Good corporate governance leads to better results for companies and for investors by creating long-term sustainable economic value.

In addition, when SOX is fully implemented, the end result should be a reduction in the number of small companies reporting restatements and material weaknesses in internal controls. With respect to companies with market capitalization under $100 million, 548 companies have reported restated financial statements in 2003 and 2004, representing 48% of total financial restatements, and smaller public companies restate twice as often as the largest public companies.[5] Although SOX Section 404 requirements have been

---

[1] Public Law 107–204—July 30, 2002. Management Assessment of Internal Controls, http://www.sec.gov/about/laws/soa2002.pdf.
[2] Rivlin, G. Those I.P.O.'s Are Sizzling Hot. Uh-Oh. *The New York Times,* January 9, 2004.
[3] Source: www.ipomonitor.com
[4] Gompers, P., Ishii, J., & Metrick, A. Corporate Governance and Equity Prices. *Quarterly Journal of Economics, 18*(1), 4, February 2003.
[5] Glass Lewis and Company Trend Alert: Restatements – Traversing Shaky Ground, May 2005.

delayed by the U.S. Securities and Exchange Commission ("SEC") for small companies until July 15, 2006, 600 small companies have already reported material weaknesses in the 18 month period ending June 30, 2005.[6] It appears that SOX is working as Congress intended and the quality of financial reporting is improving.

3. Do you believe SOX has enhanced, or diminished, the value of smaller companies? Please explain.

SOX appears to have enhanced the value of small and large companies alike. (See answer to question number 2.)

4. Has the current securities regulatory system, including SOX, increased or decreased the attractiveness of U.S. capital markets relative to their foreign counterparts for companies? For investors? Please explain.

SOX can be viewed as contributing to the attractiveness of investing in the U.S. capital markets.

The market capitalization of Nasdaq and the New York Stock Exchange and Nasdaq have increased from $11.6 trillion at the end of 2002 to $17.4 trillion as of June 30, 2005[7] indicating the attractiveness of U.S. capital markets. In addition, a survey conducted in 2004 by Broadgate Consultants Inc., the Value Alliance and the Bank of New York found that SOX has had a minimal impact of them. Of the 143 survey respondents representing companies headquartered in 43 different countries (48% in the European Union), only 8% believed that SOX would lead them to reconsider U.S. market participation and 82% believed that financial transparency was very important to the performance of their stock.[8] As of December 31, 2004, there were 1,240 foreign companies registered and reporting with the SEC.[9] As further evidence of the economic value of effective governance, "a study of 2,500 international companies by GovernanceMetrics International found that the reforms have led a 10 per cent improvement in the corporate governance performance of large US companies compared with their foreign counterparts."[10] This positive effect should be even more pronounced with small companies.

---

[6] Glass Lewis and Company Trend Alert: Control Deficiencies – Finding Financial Impurities, June 2005.
[7] Source: NYSE and Nasdaq
[8] Simpson, J. ADR Issuers Here to Stay Despite Sarbanes-Oxley Governance Standards. *PR Newswire Association, Inc,* May 2004.
[9] Source: Office of International Corporate Finance, Division of Corporation Finance, U.S. Securities and Exchange Commission.
[10] Healy, T. and Steel, S. Sarbanes-Oxley has let fresh air into boardrooms. *The Financial Times,* July 29, 2005.

5. Does the current securities regulatory system adversely impact or enhance this country's culture of entrepreneurship? Has the current system impaired or enhanced the ability of American companies to compete on a global basis? If so, how?

SOX appears to have enhanced the U.S. culture of entrepreneurship. The current securities regulatory system in the U.S. encourages reliable, transparent financial reporting and increases investor confidence, which fosters the U.S. business culture of entrepreneurship by providing greater access to investment capital. Investor confidence in financial reporting is critical to capital formation. SOX has enhanced investor confidence in the U.S. financial markets and U.S. companies are delivering positive financial performance as indicated by the growth in earnings in the S&P 500 and Russell 3000. Moreover, the Big Four accounting firms conducted a survey of 90 clients and found "that as companies become more familiar with Section 404, the amount they spend to comply with it may drop this year, by as much as 46 percent…"[11]

The formalization of corporate governance under SOX continues to be exported in various forms around the globe. This is a positive trend for investors everywhere as it will result in greater transparency and increase the likelihood of the identification of problems early on so they can be remedied on a timely basis.

6. Has SOX resulted in a diversion of the attention of company management away from operational activities, or otherwise imposed an opportunity cost on the management of smaller public companies? If so, have the benefits of SOX justified the diversion or opportunity cost? Please explain.

SOX has caused necessary and appropriate attention to be placed on operational activities, particularly on financial controls and reporting. Since the enactment of the 1977 Foreign Corrupt Practices Act, companies have been required to maintain good financial controls. However, the SEC was previously at a serous disadvantage because it could only react after significant problems already occurred since the SEC had no way of knowing in advance if controls were missing or whether there were material weaknesses. That disadvantage has now been remedied under SOX Section 404 and the Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2. Companies are now required to document their internal financial reporting controls, use independent auditors to test the practices, and disclose material weaknesses. The SEC will now have better information on a timely basis that will allow it to do a more effective job of addressing issues arising from material control deficiencies. Overall, SOX Section 404 improves financial reporting at public companies for the benefit of all investors.

Moreover, the opportunity cost is not the result of the SOX regulatory environment, but rather the cost to companies and investors to fix accounting errors resulting in financial

[11] Glater, J. Here It Comes: The Sarbanes-Oxley Backlash. *The New York Times*, April 17, 2005.

restatements. SOX Section 302 requires CEOs and CFOs to certify the financial statements are fairly presented in all material respects.[12] After three years of these certifications, in many cases investors have still been misled. Research conducted by independent research firm, Glass Lewis and Company ("Glass Lewis"), found that 48% of the companies restating their financial statements in 2003 and 2004 were small companies with market capitalizations of less than $100 million. Stronger internal controls will significantly reduce opportunity costs for companies when financial statements are prepared based on more accurate information thereby reducing or eliminating the likelihood of future financial restatements. The cost of corruption and significant financial errors are higher than the cost of regulation.

7. **Does the current securities law disclosure system properly balance the interests of investors in having access to complete and accurate information for making investment decisions with the need for companies to protect information for competitive reasons? Please explain**.

No. Transparency is important to investors, but there remains room for improvement. Disclosing additional meaningful information so investors can make more informed investment decisions does not mean that companies will be required to disclose trade secrets that would put them at a competitive disadvantage. Examples of areas where investors would like to see more complete, plain English disclosures include executive compensation, key financial performance indicators, and segment disclosures.

8. **Has the current securities regulatory system had an impact on the amount and type of litigation to which smaller companies are subject? Has the overall impact on companies, investors and markets taken as a whole been positive or negative? Please explain.**

SOX has resulted in the positive trend of shareholders' receiving a higher percentage of estimated damages in cases alleging accounting fraud, restatements and regulatory enforcement actions.[13] However, when Congress passed the Private Securities Litigation Reform Act ("PSLRA") in 1995, it mandated a heightened burden of proof requirement that securities complaints must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. 78u-4(b)(2). This increased burden of proof is very difficult to meet even in meritorious cases and has been described by some as coming "close to requiring clairvoyance, or at least near omniscience, from securities plaintiffs.[14]"

---

[12] Public Law 107–204—July 30, 2002, SEC 302. Management Assessment of Internal Controls, http://www.sec.gov/about/laws/soa2002.pdf.

[13] Simmons, L. and Ryan, E. Post-Reform Act Securities Settlements, December 2004.

[14] Patrick, K. Ease burden on plaintiffs; Private Securities Litigation Reform Act. *The National Law Journal*, June 2005.

According to NERA Economic Consulting, the bursting of the stock market bubble is dominating current trends in shareholder class action settlements and behind the extraordinary settlements are extraordinary investor losses, which is the single most important predictor of settlement size. In addition, federal filings were flat in 2004 at 238, compared to 234 in 2003 and federal filings in 2001-2003 were impacted by the analyst and mutual fund fraud cases, which it is anticipated will not occur again in the future. If the analyst and mutual fund fraud cases are excluded from each year's filings, the remaining 202 filings in 2003 and 217 filings in 2004 are in line with the post-PSLRA average of 212 filings each year.[15]

According to research conducted by Glass Lewis, the number of companies with under $100 million in market capitalization that restated their financial statements rose from 266 in 2003 to 282 in 2004, a 6% increase. In addition, 600 companies of this size have also reported material weaknesses in internal controls in 2004 and through June 30, 2005.[16] As a result of this increase in public company violations of federal investor protection laws, it should be expected there would be increased litigation activity given the recent financial scandals as investors seek to recover losses. Moreover, because investor recovery rates tend to be low, investors also view shareholder class actions as a valuable corporate governance tool to deter future fraud. As a result, the overall impact on companies, investors and markets taken as a whole has been positive.

9. Has SOX changed the capital raising plans of smaller companies? If yes, how have those plans changed?

SOX does not appear to have changed the capital raising plans of companies. Two hundred forty-two companies conducted initial public offerings in 2004 and a greater number are projected to do so in 2005.[17] The current regulatory environment requires more accurate and reliable financial reporting that permits better due diligence and that should, over time, reduce the cost of capital for small companies that meet the requirements of SOX, including Section 404. While we do not agree with the one-size-fits-all approach, we agree that effective corporate governance can be a competitive advantage for companies of all size. Capital will continue to flow to companies with effective governance practices that create sustainable economic value and the markets will punish those companies with poor governance and unsustainable financial performance.

---

[15] Buckberg, E., Foster, T., Miller, R., & Plancich, S. Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements. *NERA Economic Consulting – How Markets Work*, February 2005.
[16] Recent Trends in Shareholder Class Action Litigation, NERA Economic Consulting, February 2005.
[17] Rivlin, G. Those I.P.O.'s Are Sizzling Hot. Uh-Oh. *The New York Times*, January 9, 2004.

9a. Has SOX affected the thinking of smaller companies about buying or being acquired by other companies or looking for merger partners or acquisition targets? Explain your answer and indicate any way in which SOX has changed a smaller company from a buyer to a seller of a business, or vice versa.

SOX appears to facilitate mergers and acquisitions leading to more economically efficient enterprises. SOX has resulted in greater investor confidence in the accounting of publicly traded companies and some believe that it has been a main driver in the increased number of mergers and acquisitions in 2004. According to Thompson Financial, the number of deals increased from 7,699 in 2003 to 8,377 in 2004, an increase of 9%. Deals in 2003 totaled $567 billion, compared to $834 billion in 2004, an increase of 47%,[18] and "the first six months of 2005 were the strongest in two years."[19] Overall, the net effect of SOX on transactions appears to be positive.

<u>SOX Section 404/Internal Controls</u>

10. In developing a "risk-based" approach for assessing and auditing internal control over financial reporting for smaller companies under SOX Section 404, what criteria would you use to categorize internal controls from the highest risk to the lowest risk controls?

Using a risk-based approach for categories of internal controls, high-risk controls should focus on those that materially affect financial performance and the organization's sustainability as a going concern. As noted by the Committee of Sponsoring Organizations Treadway Commission ("COSO"), "No company, regardless of size or business, is immune from the possibility that fraudulent financial reporting will occur. That risk is inherent in doing business… At the same time, however, management's primary responsibility for reliable financial reporting should be emphasized."[20]

Small companies typically have fewer personnel on their accounting and finance staff, which can result in control risk issues such as the lack of segregation of duties and greater reliance on senior executives. In accord, research conducted by COSO noted that the nature of the companies involved in financial statement fraud cases were mostly small companies in the range below $100 million in total assets. In addition, CEOs and CFOs were associated with the fraud in 83% of the cases and 25% of the companies did not have an audit committee or had audit committees that met only once a year.[21]

---

[18] Hechler, D. M&A liftoff in the new era of SOX; Some lawyers assert that Sarbanes-Oxley helped boost the rise in deals last year. *The National Law Journal,* February 7, 2005.
[19] Sullivan, J. Foreward: Merrill Corporation. *Deal Drivers: The Comprehensive Review of North American Mergers and Acquisition,* July 2005 Edition – Half Year 2005 Data.
[20] Report of the National Commission on Fraudulent Financial Reporting: October 1987, p. 6. Research Sponsored by the Committee of Sponsoring Organizations of the Treadway Commission. 1987.
[21] Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies. Research Sponsored by the Committee of Sponsoring Organizations of the Treadway Commission. 1999.

Accordingly, a risk-based approach to auditing financial statements should include the following:

(a) The key role of the independent audit committee;

(b) The key role of executives in overriding controls;

(c) A focus on the absence of segregation of duties;

(d) An effective internal audit and governance function that reports directly to the board of directors audit committee of the board of directors;

(e) The need for qualified accounting and finance personnel;

(f) An effective whistleblower program for employees to report wrongdoing directly to an independent party such as the audit committee.

(g) The ability to identify and manage change on a timely basis as the company grows.

11. Do you believe that at least some SOX Section 404 internal controls for smaller companies can be appropriately assessed less often than every year? If so, what SOX Section 404 internal controls do you think need to be assessed by management ever year?

No. In light of the fact that smaller public companies restate their financial statements twice as often as the largest companies,[22] SOX already provides sufficient flexibility in determining materiality assessments on internal controls. More importantly, when a company raises funds from the investing public, it assumes an obligation of public trust and accountability necessary to protect the public interest, which includes effective internal controls. Investors who fund new companies should be treated fairly and be given reasonable information about the business in which they invest.

In addition, SOX Section 404 requires that controls be tested on an annual basis as follows:

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

(a) RULES REQUIRED.—The Commission shall prescribe rules requiring *each annual report* (emphasis added) required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

[22] Glass Lewis and Company Trend Alert: Restatements – Traversing Shaky Ground, May 2005.

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
(2) *contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures* (emphasis added) of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.[23]

Accordingly, it would be a violation of SOX Section 404 to permit testing of internal controls on anything other than an annual basis. Moreover, according to the PCAOB, "testing controls throughout the year will provide several benefits, perhaps the most important of which will be to fully integrate the audit of internal control over financial reporting with the audit of the financial statements."[24]

As a practical matter, effective internal controls require periodic maintenance to determine whether they are operating as intended. Key controls must be tested on an annual basis. A June 2005 report issued by Glass Lewis found that only 43% of companies that received a qualified opinion on internal control effectiveness had previously cautioned investors that deficiencies existed and 94% had certified their internal controls pursuant to SOX Section 302 as recently as the quarterly filing before the annual report was issued with a qualified opinion.[25]

11a. What controls do you think need to be assessed at least every two years?

Those controls which fall below the material or significant thresholds as determined by the audit committee or the auditor. Making the auditor perform enough of the testing to provide evidence for the auditor's opinion, as opposed to management's evidence, is the hallmark of good auditing and should not be changed.

11b. What controls do you think could be assessed only once every three years?

See response to question 11b.

---

[23] Public Law 107–204—July 30, 2002, SEC. 404. Management Assessment of Internal Controls, http://www.sec.gov/about/laws/soa2002.pdf.
[24] PCAOB Staff Questions and Answers – Auditing Internal Control Over Financial Reporting. May 16, 2005, p. 17.
[25] Glass Lewis and Company Trend Alert: Control Deficiencies – Finding Financial Impurities, June 2005. The number of companies with market capitalization less than $100M reporting material weaknesses in 2005 is as of June 30. The 354 reported consist of 239 as of May 2, and an additional 115 from May 2 through June 30.

12. Current standards require that the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. Are there specific controls for smaller companies for which the auditor should appropriately be permitted to rely on management's testing and documentation? Are there specific controls for smaller companies where this is particularly not the case?

PCAOB Auditing Standard No. 2 is the appropriate auditing standard to apply to small and large companies alike. The reporting on controls should be done by whoever does the testing. It would be misleading to investors for independent auditors to report on the effectiveness of internal controls and sign their names, if the testing was actually performed by non-independent management. The credibility of the audit firms has already been called into question over the sheer volume of undetected misstated financial statements where they had previously given these companies unqualified audit opinions. Auditors issuing their own independent audit opinions in reliance on testing by management, which have a vested interest in the outcome of the results, would only add to the erosion of external auditor credibility.

Research conducted by COSO found that the nature of the companies involved in financial statement fraud cases were mostly small companies in the range below $100 million in total assets. In addition, CEOs and CFOs were associated with the fraud in 83% of the cases.[26]

According to research conducted by Glass Lewis, it is interesting to note that 514, 619 and 850 companies in 2003, 2004 and 2005 respectively, filed financial statements with errors that later had to be restated even though a number of them had previously been certified as having effective controls under SOX Section 302.[27]

13. Is the cost and timing of SOX Section 404 certification a deterrent to smaller companies going public? Are there companies where this deterrent is appropriate? (i.e., are there companies that should not go public and is SOX Section 404 one appropriate control on the process?) If there is such a deterrent, would it be appropriate to provide some exemption or special consideration to companies that have recently gone public, and for how long would you extend this special treatment?

SOX compliance is equivalent to the Good Housekeeping Seal of Approval. A company should not consider being listed in the U.S. without it. Few, if any, institutional investors would invest in it. Companies with ineffective internal controls create a significant risk of producing misleading financial statements and these companies should not have access to the public capital markets. When a company raises funds from the public, that

[26] Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies. Research Sponsored by the Committee of Sponsoring Organizations of the Treadway Commission. 1999.

[27] Source: Glass Lewis. Number of restatements in 2005 is through June 30.

company assumes an obligation of public trust and accountability necessary to protect the public interest. It is key to the capital formation process that investors who fund new companies be treated fairly and be given reasonable information about the business in which they invest. Therefore, carving out various regulatory exemptions from this underlying principle, which would create a substandard, risky category of public companies, should not be permitted.

From 2000 through 2002, the U.S. capital markets experienced a hundred year flood event as the Nasdaq dropped from a high of 5048.62 to a low of 1114.11 and the New York Stock Exchange also experienced a sharp drop in value.[28] Market participants watched as trillions of dollars of market capitalization vaporized, in large part, due to a lack of investor confidence in the reliability and accuracy of public company financial statements.

In addition, lessons can be learned about the negative effects of creating a substandard, risky category of public companies by looking at Regulation S-B companies. Regulation S-B permits special disclosure requirements for small business issuers with revenues of less than $25,000,000 which has impaired their ability to attract analyst coverage and contributes to a lack of liquidity in their stock.[29] Moreover, audit firms tend to reject these companies as audit clients because they are viewed as being too risky and institutional investors avoid them as well. The end result is these companies typically face a higher cost of capital and are not generally viewed as attractive investments by most institutional investors.

14. Do the benefits of SOX Section 404 outweigh its costs for smaller companies? Please explain.

Yes. The benefits of SOX Section 404 outweigh the costs and include restoring investor confidence in the financial markets and the reliability of public company financial reports. This renewed investor confidence has contributed to a significant increase in initial public offerings and mergers and acquisitions activity since the dot.com bubble burst.

SOX Section 404 improves internal controls and increases the accuracy and timeliness of financial information. Management benefits include better data to manage the company and, consequently, create greater shareholder value. Overall, SOX Section 404 has the greatest long-term potential to improve financial reporting at public companies for the benefit of all investors.

[28] Source: NYSE and Nasdaq
[29] Regulation S-B (17CFR 228). Integrated Disclosure System for Small Business Issuers, March 2005.

14a. Would you support a total exemption from SOX Section 404 requirements for smaller companies? Why or why not?

Yes, but only if they remained private companies. At private companies, lenders generally scrutinize the financial statements and monitor business practices closely. In contrast, when a company raises funds from the public, that company assumes an obligation of public trust and accountability necessary to protect the public interest. It is key to the capital formation process that investors who fund new companies be treated fairly and be given reasonable information about the business in which they invest. All public companies should be required to produce fair and accurate financial reports, which SOX assures for the benefit of investors.

14b. Would such an exemption have a negative effect on investors' interests or perception regarding smaller companies? Why or why not?

Yes. See response to question 13.

<u>Accounting/Auditing</u>

15. Has SOX affected the relationship of smaller companies with their auditing firms? If yes, how? Is the change positive or negative?

SOX Section 301 significantly strengthened the audit committee's relationship with the external auditors by requiring the SEC to adopt rules that require, as a condition to stock market listing of a company's securities, that the company's audit committee be directly responsible for the appointment, compensation, and oversight of the work of the company's auditors, including resolution of disagreements between management and the auditor. In addition, SOX requires that the external auditor report directly to the audit committee.[30]

However, in both the pre and post-SOX environment, companies with effective internal controls generally experience positive working relationships with their external auditor. Conversely, one can reasonably expect that companies with weak or inadequate internal controls may have a less positive relationship with their external auditors until their controls are remedied. The impact of SOX over the long term can only be positive for both companies and investors.

As Glass Lewis notes, 1,609 companies, including 1,323 companies with market capitalization of under $100 million changed auditors in 2004.[31] Through June 30, 2005, 892 companies, including 657 with under $100 million in market capitalization, have

[30] Public Law 107–204—July 30, 2002, SEC. 301. Management Assessment of Internal Controls, http://www.sec.gov/about/laws/soa2002.pdf.

[31] Glass Lewis Trend Alert: Auditor Turnover Gains Momentum in 2004, February 2005.

changed auditors. Glass Lewis also notes that 30% of the companies reporting a material weakness in internal controls between January 1, 2004 and June 30, 2005 changed auditors. Glass Lewis further found that 117 (19% of the total) companies reporting a restatement in 2004 reported a change in auditors.[32] It is also significant that small accounting firms who often audit small companies have a restatement rate that is nearly three times as high as that for companies audited by the four largest accounting firms, and smaller public companies restate twice as often as the largest public companies.[33]

16. Are the current accounting standards applied to all U.S. companies appropriate for smaller companies? If not, please explain what revisions to existing standards might be appropriate.

Yes. To help facilitate making informed investment decisions and to maximize investment returns, transparency in financial reporting is critical regardless of the size of a company. Therefore, all companies should be required to disclose and account for similar transactions in a comparable fashion.

The lesson learned from the dot.com bust is that a lack of transparency contributes to a lack of market discipline, ineffective utilization of capital, and ultimately a "bubble" with a significant negative impact on the capital markets and the more than 90 million Americans investing in the U.S. stock market.[34]

17. For smaller companies, would extended effective dates for new accounting standards ease the burden of implementation and reduce the costs in a desirable way? How would such extensions affect investors or markets? Would allowing a company's independent auditors to provide more implementation assistance than they are able to currently reduce such burdens or costs? Would such a step positively or negatively affect the quality of audits? Please explain.

The appropriate regulatory body should have some flexibility to permit extended effective dates or to allow independent auditors additional time to provide implementation assistance for companies to comply with SOX. However, such extension should be based on publicly disclosed "hardship" criteria and only on a case-by-case basis. Otherwise, no delay should be permitted. Further delay in implementing new accounting standards, such as those adopted by the Financial Accounting Standards Board regarding accounting for stock options as an expense or accounting for off-balance sheet special purpose entities, will cause investors to continue to receive less transparent, less comparable, poorer quality financial information. Lack of quality financial information negatively impacts the investment decision-making process.

---

[32] Source: Glass Lewis. Between Jan. 1, 2004 and Jun. 30, 2005, 1,098 companies disclosed material weaknesses, of which 327 companies changed auditor in 2004 or 2005.
[33] Glass Lewis Trend Alert: Restatements – Traversing Shaky Ground, June 2005.
[34] Richards, L. Testimony Concerning the Securities and Exchange Commission's Examinations of Mutual Funds before the Senate Committee on Banking, Housing and Urban Affairs on March 10, 2004.

Having an independent auditor examine the financial statements prepared by management is critical to the integrity and reliability of the financial information provided to investors. When auditors assist management in preparing the financial statements, auditor objectivity is impaired. There have been instances where independent auditors that have assisted management did so by providing assistance in financial engineering transactions to circumvent accounting rules such as the recent Justice Department investigation involving KPMG over the sale of abusive tax shelters to investors.

The current SEC and PCAOB auditor independence rules permit sufficient latitude to auditors to provide advice to companies who are audit clients and no changes are needed to the existing auditor independence rules. However, it is ultimately the responsibility of executive management to prepare the financial statements.

[The Advisory Committee is particularly interested in responses to questions 18-20 from companies with a market capitalization of $100 million or less.]

18. Would auditors providing assistance with accounting and reporting for unusual or infrequent transactions impair the auditors' independence as it relates to smaller companies? Would providing such assistance reduce the cost of compliance for smaller companies? What would be the impact on the quality of audits, investors or markets? Please explain.

The securities laws and related rules and regulations state it is management's responsibility to ensure the financial statements provided to investors are prepared in accordance with all applicable laws, rules and regulations. There is no special exemption for unusual or infrequent transactions.

Existing auditor independence rules and the Statement on Auditing Standard No. 1 state that auditors can provide their views on the proper accounting for a transaction.[35] Moreover, when an auditor issues an opinion on the financial statements, the auditor is opining on whether the accounting and disclosures are appropriate. The current rules do not prohibit companies from obtaining accounting advice from their auditors. Again, ultimately, management is responsible for the financial statements. A company needs to have the skills and competence required to properly account for transactions and companies that possess the requisite skills and controls are much easier to audit, provide greater transparency to investors and have better access to the capital markets.

[35] SAS No. 1, Section 110.03, Responsibilities and Functions of the Independent Auditor.

19. Is the quarterly Form 10-Q or Form 10-QSB information valuable to users of the financial statements of smaller companies? Would a system that required semi-annual reporting with limited revenue information provided in the other quarters reduce costs of compliance without decreasing the usefulness of the reported information to investors? Please explain.

Yes. The data in the interim quarterly reports is useful. The data provides good insights into the ability of management to accomplish what they have told investors they will accomplish. It also provides important data on developing trends that will affect the value of a company's stock and public debt. Information presently available to investors should not be eliminated or reduced.

20. Is segment information useful for smaller companies? Please explain.

Segment information is currently based on data used by management to run the business. Therefore, management has already determined that the information is important to the company and its long-term success.

Segment information is also very useful in assessing the accomplishments and future success of a business and its management. This information often presents differing rates of growth, margins and profitability. Eliminating this information would reduce the information currently available to investors and would be a significant disservice to investors.

21. Should accounting standards provide smaller companies with different alternatives for measuring accounting events that would reduce the amount of time that would otherwise be spent by smaller companies to comply with those accounting standards? If these alternatives were available to smaller companies, would smaller companies take advantage of them even if the results of the measurements obtained from the alternatives were less favorable to them in the short term? Why or why not?

Accounting should reflect the actual economics of an accounting transaction, with adequate disclosure to ensure full disclosure and transparency. The principle should apply to all companies regardless of size.

Yet, when companies are allowed to use alternative accounting methods for the same transaction, one of those companies cannot be disclosing the true underlying economics of the transaction and it results in investors being misled. Such disclosure inconsistencies also make it very difficult, if not impossible, to make comparisons between companies when making investment decisions.

Comparability has been one of the fundamental principles of financial reporting in the U.S. capital markets. It provides investors that ability to weigh which companies have performed the best, and which ones are likely to do so. This principle has created a system that facilitates making informed investment decisions to maximize investment returns, which attracts capital.

Corporate Governance/Listing Requirements

22. Are the listing standards of the New York Stock Exchange, the American Stock Exchange, other exchanges or Nasdaq that require a majority of independent directors and independent audit, nominating and compensation committees (or in the alternative, in the case of Nasdaq, that nomination and executive compensation decisions at a minimum be recommended or determined by a majority of the independent directors) creating a hardship for smaller companies? Are there benefits to companies and investors of these listing standards in the context of smaller companies? Do the hardships outweigh the benefits in the case of smaller companies? If so, should these standards be revised for smaller companies, and, if so, how? In each case please explain.

Corporate directors have a fiduciary duty to shareholders and the corporation they serve. Shareholders elect directors to hire, monitor, compensation, and, when necessary, terminate senior management. For directors to effectively carry out their responsibilities, they must be highly qualified and independent of the company management they oversee. Independent directors who ask tough, relevant questions improve the quality of corporate governance at companies. Independent directors add to the overall integrity of the company and significantly contribute to investor confidence in the system.

Qualified independent directors also serve a key control function, especially when they serve on audit, corporate governance, and compensation committees. If the requirement for independent directors were eliminated for these committees, that important oversight role would be significantly weakened, possibly contributing to material weaknesses, or inappropriate compensation decisions. When this higher level of risk exists, investors will require a significantly higher return their investment to compensate for the added risk.

22a. Are smaller companies experiencing difficulty finding independent directors to satisfy these listing standards (including independent directors with the required level of financial literacy and sophistication for audit committee service)? What steps are being undertaken to meet these requirements?

Smaller companies may be using narrow criteria to define what constitutes a “qualified” director. If the definition is expanded to include diversity, the potential pool of director candidates would expand and the perception that there is a shortage of qualified directors would change. In addition, companies would be well served to review existing recruitment processes to encourage a more expansive, objective process that encourage inclusion as opposed to exclusion. There are also a number of high quality director education programs conducted by institutions such as the Stanford Law School Directors’

College and the Corporate Directors Forum in San Diego where directors can obtain continuing education to obtain and enhance director knowledge and effectiveness.

23. Other than director independence and concerns related to SOX Section 404-mandated internal controls, do you believe other aspects of governance and disclosure reform are unduly burdensome for smaller companies, taking into account the benefits they provide to investors and markets? If so, please explain which items are unduly burdensome and the extent of such burden. How could the burdens be appropriately ameliorated?

No. The benefits of effective corporate governance practices and better disclosure requirements provide investors with significant benefits and increases investor confidence in the integrity of small companies. These benefits outweigh the costs, particularly for long-term investors like the Ohio Public Employees Retirement System. Given the number and magnitude of recent accounting irregularities and financial restatements and the market collapse that began in 2000, the SEC should continue to make protecting the investing public its highest priority.

24. Is the loan prohibition contained in SOX creating a hardship for smaller companies? If so, explain the manner in which this hardship is being created. Do the benefits to companies and investors outweigh the hardships? Should the prohibition be clarified to exclude certain types of transactions where conflicts of interest or a likelihood of abuse may not be present?

The loan prohibition contained in SOX does not appear to create a hardship for smaller companies. In December 2002, The Corporate Library ("TCL") conducted the first-ever comprehensive study of insider loan practices at U.S. companies entitled "My Big Fat Corporate Loan"[36] and has since updated this study in January 2004 when it published its most recent report on the issue of corporate loans entitled, "The Low-Carb Corporation Loan."[37] Although SOX effectively put a stop to the practice of giving loans to executives in 2002, most companies with outstanding insider loans *are still waiting for them to be repaid, or forgiven*. According to TCL, in 2002 the average size of these loans was $10.7 million with a total amount of indebtedness for the entire sample of $4.5 billion, which has now fallen significantly - a positive development for investors. However, some companies that are not requiring repayment and instead are forgiving the loans, are also making additional payments to meet any tax bill that might arise from the imputed income to the executive. These types of loans and payments were made in the past, not to create value for shareholders, but instead just became another form of executive compensation that were poorly disclosed to investors. Creating an opt-out for small companies to circumvent the SOX prohibition on loans to executives would be a significant disservice to investors and should not be permitted.

---

[36] Hodgson, P. My Big Fat Corporate Loan. *The Corporate Library,* December 2002.
[37] Hodgson, P. The Low-Carb Corporate Loan. *The Corporate Library,* January 2004.

Disclosure System

25. Is the relief provided by SEC Regulation S-B meaningful? Why or why not?

Regulation S-B has created a second tier of riskier companies whose filings generally lack credibility in the marketplace. This lack of credibility contributes to difficulties in obtaining Wall Street analyst coverage, impacts stock liquidity, and impairs the ability of S-B filers to attract qualified directors. Creating further regulatory exemptions for small companies will only exacerbate the problems being experienced by S-B filers because lower standards inevitably lead to the higher cost of capital and greater risk for investors.

25a. Should the SEC provide an alternative disclosure framework for smaller companies in the context of securities offerings and periodic reporting? Should the alternative framework be available to a broader category of companies than Regulation S-B is currently? Should the alternative framework be based on Regulation S-B or on a different approach? Could these steps be taken without impairing investor protection?

As a result of the lessons learned starting with Enron and continuing with AIG, long-term investors do not support any changes that will reduce the quality and disclosure of financial reports at publicly traded companies in the U.S. Creating an alternative disclosure framework for a broader category of small companies will only create confusion in the marketplace and will be the first step in the wrong direction of reducing the quality of financial reporting and disclosure.

26. Are the costs of preparing and distributing printed paper versions of proxy statements and annual reports to shareholders unduly costly for smaller companies? Describe the extent of such costs, and the amount that could be saved if the SEC allowed complete electronic delivery of documents.

No, this is part of the cost of doing business as a publicly traded company. However, to the extent that some investors would prefer to receive filings and reports in an electronic format, they should be permitted to make such a special request. However, this change should not become mandatory for all investors.

27. Will the phase-down to the final accelerated reporting deadlines for periodic reports under the 1934 Act for companies with $75 million market capitalization (ultimately 60 days for Form 10-K and 35 days for Form 10-Q) be burdensome for smaller companies? If so, please explain the manner and extent of this burden. Does the burden outweigh benefits to investors and markets for smaller companies?

The request to delay accelerated reporting deadlines in today's "electronic age" of instant messaging appears ridiculous. Small companies generally are not as complex as large companies. A possible better alternative could be to require that small public companies be permitted to use a 75 day filing deadline for their annual report, and a 40 day filing deadline for their Form 10-Q, but *only* if they must file their reports within 10 and 5 business days respectively, from when they file their annual and interim reports. If companies have the ability to publish their earnings releases, and conduct analyst calls within this time frame, then they should also have the ability to generate annual and quarterly filings on a timely basis as well.

28. Should the current limit on the amount of securities that may be sold under Securities Act Rule 701 or the $5 million threshold that triggers an additional disclosure obligation under that rule be increased or modified in any way? Please explain.

Since it has been some time since these thresholds have been adjusted, it may be appropriate to increase the $5 million limit to a $10 million limit.

Miscellaneous

29. If there is any other matter relating to the securities laws applicable to smaller companies that you wish to comment on or to bring to the Advisory Committee's attention?

If any changes are ultimately enacted pursuant to the Advisory Committee's recommendations, we sincerely hope that such changes will not have the affect of reducing the quality of financial reporting and transparency or undermine the spirit and intent of SOX, particularly Section 404. These principles should apply equally to companies of all size. In addition, in the event that changes are recommended, we strongly urge the Advisory Committee to conduct independent research and publish those finding and, as appropriate, request additional public comments before any final changes are enacted.