

# COUNCIL OF INSTITUTIONAL INVESTORS

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## Via Email

March 10, 2008

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

*Re: Proposed Amendments of Temporary Rules (File Number: S7-06-03)*

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors (“Council”), an association of more than 130 public, corporate, and union pension funds with combined assets of over \$3 trillion. As a leading voice for long-term, patient capital, the Council welcomes the opportunity to provide comments on the United States Securities and Exchange Commission’s (“SEC” or “Commission”) proposal to amend temporary rules deferring for the fifth time the full implementation of the internal control requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”) for non-accelerated filers. (“Proposal”).<sup>1</sup>

At the outset, we note that Council members have about half of their domestic equity holdings invested in indexed funds,<sup>2</sup> including investments in the Russell 2000® Index.<sup>3</sup> That index includes a number of public companies that have less than 75 million in public float and,<sup>4</sup> therefore, are “non-accelerated filers” falling within the scope of the Proposal.<sup>5</sup> Thus, Council members are directly impacted by the Proposal.

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<sup>1</sup> Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 73 Fed. Reg. 7,450 (Feb. 7, 2008).

<sup>2</sup> See Council of Institutional Investors (“Council”), Pension Fund Performance Survey 9 (Aug. 23, 2004) (on file with Council).

<sup>3</sup> See Russell 2000® Index, Fact Sheet, [http://www.russell.com/indexes/characteristics\\_fact\\_sheets/us/Russell\\_2000\\_Index.asp](http://www.russell.com/indexes/characteristics_fact_sheets/us/Russell_2000_Index.asp). (as of Jan. 1, 2008).

<sup>4</sup> *Id.*

<sup>5</sup> See 73 Fed. Reg. at 7,450 & n.11.

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The Council generally believes that it is inappropriate for the Commission to provide a fifth deferral from the full requirements of Section 404 of SOX. Section 404 is a core element of SOX and plays a vital role in ensuring high quality financial reporting and high levels of investor confidence in the markets.<sup>6</sup>

Consistent with the language and intent of Section 404 of SOX,<sup>7</sup> we generally believe any company tapping the public markets to raise capital should be required to have appropriate internal controls in place that have been subject to a meaningful review and attestation by external independent auditors.<sup>8</sup> That is particularly true for the generally riskier smaller public companies that would be the beneficiaries of the Proposal's deferral.<sup>9</sup>

The Proposal indicates that the Commission's reasons for a fifth deferral of the internal control requirements of Section 404 include:

- To enable non-accelerated filers more time to prepare and gain efficiencies in the review and evaluation of the effectiveness of internal control over financial reporting; [and]
- To provide the Commission with time to review the findings of its study [of the costs and benefits of Section 404 implementation] and to consider whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted . . . .<sup>10</sup>

We find those reasons less than convincing.

#### Non-accelerated filers do not need more time

The Council generally does not believe that non-accelerated filers need an additional year (until December 2009) "to prepare" for the implementation of Section 404. We note that "accelerated filers"—those companies with a public float of \$75 million or more— have been fully complying with Section 404 *for over three years*.<sup>11</sup>

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<sup>6</sup> See, e.g., Letter from Jeff Mahoney, General Counsel, Council, to Nancy M. Morris, Secretary, Securities and Exchange Commission 3 (Aug. 24, 2007).

<sup>7</sup> See S. Rep. No. 107-205, at 54, [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107\\_cong\\_reports&docid=f:sr205.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:sr205.pdf).

<sup>8</sup> See, e.g., Letter from Jeff Mahoney, *supra* note 6, at 3.

<sup>9</sup> See, e.g., Carlo di Floria, COSO Study on Fraud in Financial Reporting 4 (Oct. 1999) (noting that most frauds in financial reporting are "committed by smaller corporations"), [http://www1.transparency.org/iacc/9th\\_iacc/papers/day3/ws7/d3ws7\\_cdfiorio.html](http://www1.transparency.org/iacc/9th_iacc/papers/day3/ws7/d3ws7_cdfiorio.html).

<sup>10</sup> 73 Fed. Reg. at 7,453.

<sup>11</sup> See, e.g., Audit Analytics, 404 Dashboard, Year 3 Update 1 (December 2007).

We also note that there is evidence that the Commission's serial deferral of Section 404 has resulted in some public companies *serially delaying their preparation* for full implementation of Section 404.<sup>12</sup> A fifth deferral would lend further credence to the "widespread belief that another extension [or exemption] could be granted."<sup>13</sup>

Finally, we note that as a result of the recent implementation of new and more stringent internal control standards for audits of private companies, the Commission's serial deferral of Section 404 has led to the absurd result that the 2007 year-end audits of "mom & pop" businesses across the country have required greater attention to internal control attestation than the 2007 year-end audits of many public companies.<sup>14</sup> When it appears that mom and pop private companies are being held to a more rigorous internal control standard than many public companies that might suggest to the SEC that some of the Section 404 implementation concerns, that have been raised by some parties, have been grossly exaggerated.

Further study of the costs and benefits before full implementation is not warranted

The Council generally believes that the benefits of Section 404 to investors and the markets exceed the costs. Recent reports that add to the growing body of evidence supporting that conclusion include:

- A December 2007 report by Audit Analytics® analyzing the "Year 3 Section 404 Results" concluded:<sup>15</sup>

It should not come as a surprise to anyone that controls designed to protect against flawed financial reporting would result in healthier markets. As Market technology, and experiential efficiencies have driven compliance costs down, a real appreciation has emerged for how much SOX 404 has aided in the creation of a prompt and accurate financial reporting environment.

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<sup>12</sup> See, e.g., The Lord & Benoit Report: *The Sarbanes-Oxley Investment, A Section 404 Cost Study for Smaller Public Companies* 6 (Jan. 9, 2008), [http://www.section404.org/pdf/Lord\\_Benoit\\_Report\\_The\\_Sarbanes\\_Oxley\\_Investment.pdf](http://www.section404.org/pdf/Lord_Benoit_Report_The_Sarbanes_Oxley_Investment.pdf).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 3.

<sup>15</sup> Audit Analytics®, *supra* note 11, at 1.

. . . Based on these filings, it is clear that a tremendous effort has been made by both the audit industry and the companies to considerably upgrade the quality and reliability of public company financial statement reporting. Even though Year 3 has experienced an injection of new filers, the adverse SOX 404 opinion rate stands at 8.6%, down from 10.3% in Year 2 and 16.9% in Year 1.<sup>16</sup>

- A January 2008 report by Lord & Benoit, LLC on a cost study of “twenty-nine (29) non-accelerated registrants” found that:<sup>17</sup>

The average cost of complying with Section 404(a) Management Assessment for non-accelerated filers was \$53,724. Total costs of complying with Section 404(a) ranged from as low as \$15,000 for a smaller software company to as high as \$162,000. *The initial prediction by the SEC was a average cost of \$91,000 for public companies complying with Section 404(a).*

. . . .

The total average cost of complying with SOX Section 404(a) and Section 404(b) amounted to \$78,474. . . . The average cost of complying with both Sections 404(a) and (b) in this study was 0.3% of market capitalization and 0.8% of revenues.<sup>18</sup>

- A February 2008 report by BDO Seidman LLP on a survey of more than 100 chief financial officers of leading technology companies found that:

‘Although technology companies were hesitant to adopt Section 404 . . . the majority have realized improved processes due to their compliance efforts and do not believe 404 has adversely impacted their level of risk-taking . . . . ‘The CFOs at these technology companies are also very optimistic that 404 costs will stabilize this year.’<sup>19</sup>

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<sup>16</sup> *Id.* at 1.

<sup>17</sup> The Lord & Benoit Report, *supra* note 12, at 6.

<sup>18</sup> *Id.* at 3 (emphasis added & footnotes omitted).

<sup>19</sup> Press Release, BDO Seidman, LLP, CFOs Weigh in on Impact of Compensation Disclosure and SOX 404 Compliance 1 (Feb. 19, 2008).

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In conclusion, as indicated in previous comment letters to the Commission,<sup>20</sup> the Council generally believes that the full implementation of the internal control requirements of Section 404 by all public companies is essential to investor protection and is long overdue. We, therefore, respectfully request that the Commission not adopt the Proposal as a final rule.

\* \* \* \*

The Council appreciates the opportunity to provide our comments on the Proposal. Please feel free to contact me with any questions.

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney".

Jeff Mahoney  
General Counsel

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<sup>20</sup> See, e.g., Letter from Jeff Mahoney, *supra* note 6, at 4 & n.16.