WASHINGTON LEGAL FOUNDATION
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September 18, 2006

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

Re: Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting (File No. S7-11-06; Release No. 34-54122);

Internal Control Over Financial Reporting In Exchange Act Period Reports Of Non-Accelerated Filers and Newly Public Companies (File No. S7-06-03; Release No. 33-8731)

Dear Ms. Morris:

The Washington Legal Foundation (WLF) hereby submits these comments in response to the above-captioned administrative proceedings regarding the implementation of Section 404 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7262, particularly with respect smaller public companies.

As more fully described herein, WLF supports the Commission's proposal to extend the compliance deadlines for smaller public companies to provide their management's reports on internal control over financial reporting (ICFR) under Section 404. WLF further urges the Commission to develop clearer and more flexible guidance for management regarding its evaluation and assessment of ICFR, and to adopt relevant recommendations of the Commission's Advisory Committee on Smaller Public Companies.

I. Interests of WLF

WLF is a nonprofit, public interest law and policy center based in Washington, D.C., with supporters nationwide. Since its founding 29 years ago, WLF has advocated free-enterprise principles, responsible government, property rights, a strong national security and defense, and a balanced civil and criminal justice system, all through WLF's Litigation Department, Legal Studies Division, and Civic Communications Program.

WLF is filing these comments as part of its INVESTOR PROTECTION PROGRAM. The

goals of WLF's INVESTOR PROTECTION PROGRAM are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive litigation practices; to encourage congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures. Additional information about WLF's INVESTOR PROTECTION PROGRAM is available on our website at *www.wlf.org*.

As part of WLF's INVESTOR PROTECTION PROGRAM, WLF has filed several complaints with the SEC requesting formal investigation of several instances where there appeared to be a manipulation of the price of the stock by short sellers who were collaborating with class action attorneys. WLF was also invited to testify before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services of the U.S. House of Representatives in May 22, 2003, on "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: The Relationship Between Short Sellers and Trial Attorneys."

From time to time, WLF also files comments with the SEC on various matters of interest. For example, on January 26, 2006, WLF filed comments on SEC Release No. 53025 (Dec. 27, 2005) regarding the distribution of moneys placed into seven Fair Funds as a result of a settlement by the SEC with seven New York Stock Exchange specialist firms. On April 30, 2003, WLF filed comments with the SEC in response to request for public comments on the two-day Hedge Fund Roundtable.

WLF also litigates and appears as amicus curiae before federal courts in cases involving securities litigation. *See, e.g.*, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *Merrill Lynch v. Dabit*, 126 S. Ct. 1503 (2006); *Neer v. Pelino*, No. 05-4830 (3d Cir.) (WLF brief filed May 17, 2006). WLF has also filed a brief in *Free Enterprise Fund v. The Public Company Accounting Oversight Board*, C.A. No. 06-00217-JR (D.D.C.) (motions for summary judgment pending), arguing that the PCAOB is unconstitutional.

WLF's Legal Studies Division has produced and distributed timely publications on securities regulations. WLF's recently published Legal Backgrounders on the topic include: Bob Merritt, *The Sarbanes-Oxley Act: A Personal View* (WLF Legal Opinion Letter, Oct. 21, 2005); Peter L. Welsh, *Sarbanes-Oxley And The Cost Of Criminalization* (WLF Legal Backgrounder, Aug. 30, 2002); Robert A. McTamaney, *The Sarbanes-Oxley Act Of 2002: Will It Prevent Future "Enrons"?* (WLF Legal Backgrounder, Aug. 9, 2002).

More pertinently, WLF filed comments with the Commission on April 3, 2006, in support of the Final Report of the Advisory Committee on Smaller Public Companies, File No. 265-23. WLF supported easing the regulatory burden of complying with Section 404, and supported the Committee's recommendation establishing a scaled or proportional securities regulation for

smaller public companies. WLF submits that the costs of Section 404 compliance for many smaller public companies outweigh any benefits gained, and have a detrimental effect on the development of smaller companies, entrepreneurship, job creation, and the economy.

II. Comments of WLF

The evidence is overwhelming that Section 404's compliance costs are enormous even for large public companies, and are prohibitive for smaller public companies, such as "microcap" and "smallcap" companies, particularly those in the high-tech, high-growth sectors where there may be little or no initial revenues.[1] The SEC's Advisory Committee Report on Smaller Public Companies described the disproportionate compliance costs for smaller public companies, noting that smaller public companies with a market capitalization under $100 million are expected to spend over 2.5 percent of their revenues for compliance, whereas largecap companies over $1 billion are expected to spend only 0.16 percent of their revenue for compliance costs. SEC Advisory Committee Report at 33. The recent report by the Government Accountability Office (GAO) makes a similar assessment:

> Resource limitations make it more difficult for smaller public companies to achieve economies of scale, segregate duties and responsibilities, and hire qualified accounting personnel to prepare and report financial information. Smaller companies are inherently less able to take advantage of economies of scale because they face higher fixed per unit costs than larger companies with more resources and employees.

GAO, *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies* 18-19 (April 2006).

Compounding the problem is the complexity and timing of PCAOB's Auditing Standard No. 2 that establishes new audit requirements which governs both the auditor's assessment of

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[1] Generally speaking, an "accelerated filer" is a public company that has a public float of $75 million or more in stock. A company with a public float of $700 million or more is considered a "large accelerated filer". Companies that are accelerated or large accelerated filers are subject to shorter financial reporting deadlines than non-accelerated filers, *i.e.*, those companies with less than $75 million in public float, or "microcap" companies. The Advisory Committee recommended a scaled or proportional securities regulation for smaller public companies that would divide smaller public companies into two subcategories, "microcap" and "smallcap" companies. Currently, companies with an equity capitalization below $128 million would be considered "microcap" and those between $128 million and $787 million would be considered "smallcap".

management controls on financial reporting and the auditor's attestation to the management's assessment of internal control over financial reporting (ICFR) required by Section 404(b).

A. Proposed Extension of Compliance Dates.

To address these valid concerns, the SEC proposes in Release No. 33-8731 to extend the compliance dates for smaller public companies, or non-accelerated filers, for their managements' report on ICFR until they file an annual report for a fiscal year ending on or after December 15, 2007. The SEC further proposes to extend this deadline if revisions to PCAOB's Auditing Standard (AS) No. 2 have not been finalized in time to be used in connection with annual reports filed for fiscal years ending on or after December 15, 2008. Additionally, the SEC is proposing a transition period for newly public companies, regardless of the size of their float, to file one annual report with the SEC before it becomes subject to compliance with the requirements for ICFR.

Accordingly, WLF supports the SEC's proposal to extend the compliance deadlines to Section 404, and urges the Commission to consider further extending the deadline as the SEC develops additional guidance and as the PCAOB revises AS No. 2. Such extensions would be of great benefit to smaller public companies with limited personnel and resources.

In addition, in order to encourage communication between management, auditors and audit committee, the Commission states that "management should not fear that a discussion of internal controls. . . will itself be deemed a deficiency in internal control or constitute a violation of our independence rules as long as management determines the accounting to be used and does not rely on the auditor to design or implement its controls." WLF submits that the SEC should take all steps to encourage rather than discourage communication by management to comply with Sarbanes-Oxley, and where appropriate, should provide "safe harbor" provisions for doing so. WLF also supports the Commission's treatment of the management report for a non-accelerated filer for the first year to be deemed "furnished" instead of "filed" to avoid triggering the liability provisions of Section 18 of the Exchange Act.

B. Concept Release Concerning Management Reports on ICFR

The Commission has also issued a Concept Release (SEC Release No. 34-54122) soliciting public comment on a variety of issues to develop additional guidance for management regarding its evaluation and assessment of ICFR. The Concept Release properly notes the because of the limited resources of smaller public companies and other unique characteristics, that PCAOB's AS No. 2 and other implementation guidance do not adequately accommodate those characteristics.

In the first place, WLF encourages the Commission to reduce as much as possible the regulatory burden of Sarbanes-Oxley on all public companies, both large and small. WLF

particularly supports those recommendations which include partial or complete exemptions for specified types of smaller public companies until satisfactory guidance has been issued by the Commission and the PCAOB, and urges the Commission to adopt them. The current "one-size-fits-all" approach in implementing Section 404 and AS No. 2 simply lacks the necessary flexibility required for smaller public companies. This is particularly true for AS No. 2, which WLF submits should be considered as a flexible guide as to what a public accountant should consider, based on the size of the company, risk, and the professional judgment of the auditor. WLF agrees with the views espoused by Pfizer Inc. in this regard, as well as Pfizer's other comments and recommendations recently filed in this proceeding.

Indeed, as suggested by Alex J. Pollock, Resident Fellow of the American Enterprise Institute, WLF urges the Commission to reconsider making Section 404 voluntary for smaller public companies as long as they make proper disclosure to their investors as to their compliance status. The market will better decide whether capital will be drawn to such companies. Forcing smaller companies to bear the relative huge compliance costs of Sarbanes-0xley that their shareholders do not want will simply reduce shareholder value and divert the company's resources away from product development and generating revenue.

WLF submits that whatever guidance is forthcoming, it should not be encased in a rigid rule as the Commission proposes to do. Rather, the guidance should be exactly that, namely, flexible yet clear guides to enable public companies to comply with Section 404 in a way that makes sense for that company. Otherwise, public companies, both large and small, will be unfairly exposed to attacks by the Commission or the plaintiffs' trial bar for any minor deviance or misstep that does not materially affect reporting obligations.

For example, complaints have been raised that by merely asking for advice from outside auditors or others, that fact, in and of itself, may constitute evidence of "material weakness" under Sarbanes-Oxley, thereby questioning whether internal control is adequate and effective. WLF submits that the SEC and PCAOB rules and guidance should never be construed in a way that will deter management from seeking advice to comply with the law. As noted, the Commission stated that "management should not fear that a discussion of internal controls... will itself be deemed a deficiency in internal control or constitute a violation of our independence rules...." WLF reiterates it suggestion that the Commission develop "safe harbors" in any guidance so that management can reduce exposure to any claims of violating Section 404.

WLF also supports the excellent comments filed by Southern Company urging the Commission to significantly reduce the compliance requirements of Section 404. In doing so, the Southern Company put Section 404 in proper perspective vis-a-vis other provisions of Sarbanes-Oxley:

> With the disproportionate attention given to Section 404, the investing public might easily overlook how effective the <u>other</u> parts of the Act have been in improving corporate

> governance, improving internal control over financial reporting and preventing material fraud * * * * We believe that the important improvements to internal control over financial reporting resulting from the portions of the Act beyond Section 404 will meet expectations without the overly burdensome and detailed compliance requirements of Section 404 as they currently exist.

Comments of Southern Company at 2 (Sept. 14, 2006).

As WLF indicated in its earlier comments filed on April 3, 2006, internal control requirements should be "scaled" and "proportional" depending upon the size of revenues and corporate structure. As noted, many smaller companies, such as those in the biotech field, may have a market capitalization of $700 million but have product revenues of $1 million or less. Costs of complying with Section 404 and AS No. 2 in terms of manpower and fees paid to outside accountants appear to outweigh the benefits for many of these smaller public companies. In that regard, WLF agrees with the recent comments filed in this proceeding by a group of high-tech associations led by the Biotechnology Industry Organization (BIO).

Conclusion

For the foregoing reasons and those provided by other commenters, WLF urges the Commission to take all steps necessary to reduce the undue burden on public companies of complying with Section 404 of Sarbanes-Oxley, particularly for smaller public companies. In addition, both the SEC and the PCAOB should ensure that any guidance that is issued be as clear as possible, yet flexible enough to avoid needless compliance expenditures and litigation. Otherwise, entrepreneurship, job creation, and the economy as a whole will suffer.

Sincerely yours,

Daniel J. Popeo
Chairman & General Counsel

Paul D. Kamenar
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