COUNCIL OF INSTITUTIONAL INVESTORS

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Via Email

September 14, 2006

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

Re: Internal Control Over Financial Reporting in Exchange Act: Periodic Reports of Non-Accelerated Filers and Newly Public Companies (File Number: S7-06-03)

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of 140 public, corporate and union pension funds with combined assets of over $3 trillion. The Council welcomes the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") release ("Release") proposing a further extension of compliance dates for smaller public companies and a delayed transition period for newly public companies with respect to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX").

SOX was enacted in response to a shocking series of corporate scandals, including many resulting, at least in part, from lax or inadequate internal controls. The costs of these scandals—from company-specific losses to a widespread loss of confidence in the integrity of the U.S. capital markets—were staggering. All investors in the U.S. markets, from large institutional investors to individuals investing their hard-earned savings, were impacted by these frauds.

As a leading voice for long-term, patient capital, the Council believes that Section 404 is a core element of SOX and plays a vital role in restoring and maintaining investor confidence in the markets. Consistent with the requirements of Section 404, we believe any company tapping the public markets to raise capital should have appropriate internal controls, and management should be responsible for assessing those controls and receiving an auditor report on that assessment.

The Council acknowledges that the costs of compliance with Section 404 have been higher than anticipated, and that some companies have struggled in implementing its requirements. Some of the outlays can be attributed to expected one-time start-up costs associated with complying with any new regulatory requirement. Other outlays include

"deferred maintenance" expenditures required to make up for years of neglect of internal controls—controls that public companies have been required to have in place since 1977, the year the Foreign Corrupt Practices Act went into effect.

The Council does not disagree that more might be done to further reduce the costs of compliance with Section 404. For example, we continue to support the issuance of additional "practical, plain English guidance to management on how to assess the effectiveness of internal control over financial reporting."[1]

Proposed Extension of Internal Control Reporting Compliance Dates for Non-Accelerated Filers

At the May 10, 2006 roundtable on second-year experiences with the internal control reporting and auditing provisions of Section 404, the Council indicated that it would not oppose one additional modest extension of the compliance dates for internal control over financial reporting requirements for non-accelerated filers. We note that the Release proposes a modest five month delay from compliance with the management assessment requirement.[2] The Release, however, also proposes an unacceptably lengthy seventeen month delay from compliance with the auditor attestation report requirement.[3] Perhaps more troubling, the Release suggests that further delays may be forthcoming for both requirements if additional guidance to either management or auditors is not finalized in time to "be of assistance."[4]

The Council does not believe that a seventeen month delay of a critical component of Section 404, or the serial extension of the Section 404 requirements is in the best interest of investors for several reasons. First, the Council believes that the Section 404 requirements are far more important to investors of the generally riskier smaller public companies than the larger public companies.[5] The evidence indicates that smaller public companies are prone to more misstatements and restatements of financial information, and make up the bulk of accounting fraud cases.[6] The list of companies involved in stock-option backdating provides a recent example of this phenomenon.

We note that our members on average have more than fifty percent of their assets invested in index funds, including the Russell 3000 index. If the Release were adopted,

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[1] Letter from Ann Yerger, Executive Director, Council of Institutional Investors, to The Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission and The Honorable Bill Gradison, Acting Chairman, Public Company Accounting Oversight Board (May 17, 2006), page 3.
[2] Release Nos. 33-8731; 34-54295; File No. S7-06-03 (August 9, 2006), page 10.
[3] Id.
[4] Id. at page 12.
[5] "Separate Statement of Kurt Schacht, CFA, Executive Director, CFA Centre for Financial Market Integrity Relating to the Final Report of the SEC Advisory Committee on Smaller Public Companies" (February 23, 2006), page 10.
[6] Id.

forty-two percent, or nearly 1,300 companies, would not be required to comply with the Section 404 requirements until December 2008, more than six years after SOX was enacted.

Second, the Council believes that there is significant anecdotal evidence that many smaller public companies have not taken advantage of the three previous delays of the Section 404 requirements to prepare for the implementation of those requirements.[7] We are not confident that a fourth delay, with the SEC suggesting a possible fifth delay, will change that behavior.

Third, the Council notes that two of the previous delays in Section 404 compliance were premised largely on the need for the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to develop and issue guidance to assist smaller companies in applying the COSO framework. This past June, COSO issued "Internal Control over Financial Reporting—Guidance for Smaller Public Companies."[8] Although we support the issuance of additional Section 404 implementation guidance for management and auditors, the COSO guidance appears to provide sufficient principles-based tools with many examples to "provide a basis" for smaller companies to begin to comply with Section 404 in a cost-effective manner.[9] We note that under the existing effective date for Section 404, smaller public companies would have had more than a year to review and implement the guidance contained in the COSO report.

Finally, the Council is also concerned about the Release's proposed sequential implementation of the requirements of Sections 404(a) and 404(b) of SOX. We believe the proposed inclusion of management's internal control assessment in annual reports without the accompanying auditor's attestation will likely do little more than confuse investors and further delay providing them with the level of assurance that they have long requested and deserve.

<u>Proposed Transition Period for Compliance with the Internal Control Over Financial Reporting Requirements by Newly Public Companies</u>

The Council does not believe it is appropriate or in the best interest of investors to grant newly public companies an additional year after going public before they are required to include management and auditor attestation reports on internal control over financial reporting in their annual reports filed with the Commission. As indicated above, we believe that the Section 404 requirements are a core element of the reforms resulting from SOX, and that all public companies should have appropriate internal controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

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[7] "PCAOB Member: In Some Ways, SOX Inevitable," WebCPA (September 13, 2006).
[8] COSO, "Internal Control over Financial Reporting—Guidance for Smaller Companies (June 2006).
[9] Id. at FAQ, Item 20.

The Release indicates that the primary basis for the proposal to delay the application of Section 404 to newly public companies is the concern that compliance with the Section 404 requirements

> could affect a company's decision to undertake an initial public offering or to list a class of its securities on a U.S. exchange or a company's timing decisions with regard to such an offering or listing. During our roundtable on May 10, 2006, we received comments indicating that some private companies are more likely to consider alternative capital markets in view of the regulatory hurdles that newly public companies face in the U.S. We believe that the current due date for filing the first Section 404 reports may exacerbate that disincentive."[10]

The Council rejects the notion that Section 404 or any other core element of our regulatory system for public companies should be deferred or otherwise softened to prevent a "disincentive" for initial public offerings ("IPOs") to be listed in the U.S. We believe the Section 404 requirements contribute to the higher valuation premium afforded those companies that qualify to list on the U.S. exchanges.[11] For example, an April 2006 study on "The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital" found "clear evidence" that compliance with Section 404 lowered public companies' cost of capital.[12] Deferral or other perceived dilutions of the Section 404 requirements for newly public companies or any category of public companies would likely diminish the U.S. market premium.[13]

Moreover, it should be noted that the U.S. continues to be the largest national source of IPO activity in the world, with a record-setting 210 IPOs and $33 billion in capital raised in 2005.[14] In addition, May 2006 was one of the most successful months for IPO's in the U.S. since the high-tech bubble burst, and the first five months of 2006 saw an almost twenty percent increase in U.S. IPOs from the comparable period in 2005.[15] Finally, a recent survey of 108 U.S. technology-based private companies found that "when companies were questioned about whether their decision to go public was delayed by

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[10] Release Nos. 33-8731; 34-54295; File No. S7-06-03, page 18.
[11] See Kate O'Sullivan, "The Case for Clarity," CFO Magazine (September 1, 2006), page 2 of 4.
[12] Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr. & Ryan LaFond, "The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital" (April 2006), page 6.
[13] See Kate O'Sullivan, "The Case for Clarity," CFO Magazine, page 3 of 4.
[14] Ernst & Young/Thomson Financial, "Accelerating Growth Global IPO Trends 2006," page 19.
[15] "Learning to Live with Sox," CIO Insight (June 6, 2006), pages 3 of 5 & 4 of 5.

SOX, companies highly disagreed with the statement that SOX was a reason for the delay."[16]

In conclusion, Section 404 was enacted as key part of a regime of important investor protections. The time has come for all public companies—large or small, newly formed or long established—to begin to fully comply with all of the requirements of Section 404.

The Council appreciates the opportunity to comment. We would be happy to respond if you have any questions or need additional information.

Sincerely,

Jeff Mahoney
General Counsel

[16] Lynn Stephens & Robert G. Schwartz, "The Chilling Effect of Sarbanes-Oxley: Myth or Reality?," CPA Journal (June 2006), page 4 of 5.