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February 26, 2007

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SEC File No. S7-24-06: Management's Report on Internal Control Over Financial Reporting, 71 Fed. Reg. 77635 (Dec. 27, 2006)

Dear Ms. Morris:

The Washington Legal Foundation (WLF) hereby submits these comments in response to the above-captioned proceeding proposing an interpretative guidance on management's evaluation of its internal control over financial reporting (ICFR). The proposed guidance is based on what the SEC asserts is a "top-down, risk-based evaluation of internal control over financial reporting" that should assist "companies of all sizes" to comply with Section 404(a) of the Sarbanes-Oxley Act of 2002. 71 Fed. Reg. 77635. The Commission is also proposing amending a rule to require only one auditor attestation report under Section 404(b) on the effectiveness of management's internal controls reporting.

While WLF applauds efforts by the SEC to make it easier for smaller public companies to comply with Section 404, we are still concerned that the SEC has not fully considered providing exemptions from compliance for smaller public companies that bear disproportionate compliance costs, as recommended by the SEC's Advisory Committee on Smaller Public Companies. WLF also urges the Commission to delay the effective date for compliance until December 2008 in order to provide management sufficient time to implement whatever guidance or rule the Commission ultimately adopts.

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 30 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 also testified 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."

WLF also filed 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). 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).

Of particular relevance to the instant proceeding, WLF filed comments with the Commission on April 3, 2006, in support of the *Final Report of the Advisory Committee on Smaller Public Companies* (*Advisory Committee Report*). 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. In addition, on September 18, 2006, WLF filed comments supporting the Commission's proposal to

extend compliance deadlines for smaller public companies to provide their management's reports on ICFR, and to adopt relevant recommendations of the Commission's Advisory Committee on Smaller Public Companies. WLF believes 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. SEC's Proposed Interpretive Guidance

The SEC proposes to adopt interpretative guidance regarding an issuer's evaluation of ICFR. As noted, the proposed guidance is based on what the SEC asserts is a "top-down, risk-based evaluation of internal control over financial reporting" that should assist "companies of all sizes" to comply with the Section 404 of SOX. The SEC recognizes that since it first adopted rules in June 2003, many companies have developed their own internal rules to evaluate their ICFR, while others retained outside consultants or purchased commercial software to establish their ICFR evaluation process. 71 Fed. Reg. 77636. The SEC states that "it is important to note that our rules do not mandate the use of a particular framework, since multiple viable frameworks exist and others may be developed in the future."

The SEC also notes that the Final Report issued on April 23, 2006 by the Commission's Advisory Committee on Smaller Public Companies raised several concerns about the burdens and costs imposed on smaller public companies or non-accelerated filers to comply with Section 404.[1] In particular, the Advisory Committee noted three distinguishing characteristics of smaller companies that should be taken into account in formulating guidance or regulations implementing Section 404:

> (1) The limited number of personnel in smaller companies, which constrains the companies' ability to segregate conflicting duties; (2) top management's wider span of control and more direct channels of communication, which increase the risk of management override; and (3) the dynamic and evolving nature of smaller companies, which limits their ability to have static processes that are well-documented.

71 Fed. Reg. 77637 (footnote omitted). Accordingly, the Advisory Committee recommended partial or complete exemptions for smaller public companies from the internal control reporting requirements, unless and until a framework was developed that took into account the needs of smaller public companies for assessing ICFR.

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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. Non-accelerated filers are smaller public companies with a market capitalization under $75 million. Those smaller companies constitute 44 percent of the listed public companies in 2005. *See Advisory Committee Report* at E3.

In April 2006, the Government Accountability Office issued a Report to the Senate Committee on Small Business and Entrepreneurship, entitled *Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies* (*GAO Small Business Report*). That report recognized the problems associated with smaller public companies complying with Section 404, particularly noting that management's compliance was centered around Auditing Standard No. 2 issued by the Public Company Accounting Oversight Board (PCAOB) because guidance from the SEC was otherwise lacking. Subsequently, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) adopted a framework in July 2006 entitled *Internal Control over Financial Reporting - Guidance for Smaller Public Companies* that was intended to assist smaller companies in applying the COSO framework by providing a variety of approaches for management to evaluate ICFR.

The SEC now proposes a guidance that "does not provide a checklist of steps management should perform in completing its evaluation" of its ICFR. Rather, it is designed to be flexible and allow management to tailor its evaluation to the company's individual circumstances. The SEC guidance is based on two principles: (1) that "management should evaluate the design of the controls that it has implemented to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner;" and (2) that "management's evaluation of evidence about the operation of its controls should be based on its assessment of risk." The Commission believes that this "top-down, risk-based approach" would allow "companies of all sizes and complexities . . . to implement our rules effectively and efficiently." 71 Fed. Reg. 77639.

III. WLF Comments

As noted, while the SEC's proposed guidance is intended to assist companies of all sizes to comply with Section 404, WLF believes that the Commission should take further steps to exempt smaller public companies from burdensome and costly regulation under Section 404. 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.

In that regard, WLF supports the comments filed by UFP Technologies, a smaller public company, whose shareholders would rather see resources devoted to compliance be used instead for product development, sales, and growth. In addition, if the Commission does not exempt smaller public companies, it should consider whether external audits are necessary for such companies, the cost of which can be excessive. According to the Government Accountability Office, accounting costs for a smaller public company can run as high as $1.4 million. *GAO Small Business Report* at 17. Those compliance costs are approximately 2.55 percent of revenue, whereas for larger companies with a market capitalization over $1 billion, compliance costs are approximately 0.16 percent of revenue. *See Advisory Committee Report* at 29.

At a minimum, inasmuch as the SEC released the proposal only two months ago, WLF recommends delaying the compliance date for smaller public companies as suggested by the International Association of Small Broker-Dealers and Advisors. WLF shares their concern that the effective date of these proposed rules should take effect for fiscal years ending on or after December 15, 2008 in order to give companies and auditors more time to assimilate and implement all the auditing requirements, software, and other measures needed to comply with Section 404.

WLF notes that the proposed guidance "assumes management has established and maintains a system of internal accounting controls as required by the [Foreign Corrupt Practices Act] FCPA." 71 Fed. Reg. 77639. WLF concurs with the comments filed by Peter J. Wallison, Senior Fellow of the American Enterprise Institute, with respect to SEC's adding the "safeguarding of assets" under the rubric of internal control of financial reporting. Specifically, Congress did not intend for Section 404 of Sarbanes-Oxley to cover unauthorized use or disposition of assets which were included in controls required under FCPA. Controls under FCPA do *not* have to be certified by the issuer's auditors; therefore, adding that subject area for regulation under Section 404 would simply impose unnecessary costs on all issuers.

We also share the concerns expressed by Minn-Dak Farmers Cooperative in their comments that SEC audit guidelines should allow management to use a common sense approach to proper internal control for financial reporting in order to reduce unnecessary costs for smaller companies. Unfortunately, Minn-Dak was unable to even meet with their auditors to discuss the proposed guidance and rule because of the auditors' fear that they would be criticized by the SEC. The SEC's regulatory atmosphere appears to have a chilling effect on communications between management and auditors that should not exist. WLF submits that the SEC should take all steps to encourage rather than discourage communication by management to comply with Sarbanes-Oxley.

Finally, WLF urges the Commission and the PCAOB to reconcile their rules on this subject to avoid confusion. Auditors will likely follow the more rigid PCAOB rules rather than the more vague and flexible SEC guidance for fear of incurring the enforcement wrath of the PCAOB, thus defeating the very purpose of the SEC's proposed guidance.

Conclusion

For the foregoing reasons, WLF urges the Commission to take additional steps to reduce the undue burden on public companies, particularly smaller public companies, for complying with Section 404. In addition, the SEC should make whatever guidance it does adopt as clear as possible, and specify that the guidance is voluntary rather than mandatory. Finally, the SEC should specify in greater detail exactly how following any proposed guidance would serve as a non-exclusive safe harbor for complying with Exchange Act Rules 13a-15(c) and 15d-15(c).

The SEC should also make it clear that companies are free to adopt other methods of evaluating the effectiveness of their ICFR.

Sincerely yours,

Daniel J. Popeo
Chairman and General Counsel

Paul D. Kamenar
Senior Executive Counsel