Consumer Federation of America
Consumer Action
Consumers Union
U.S. Public Interest Research Group
Fund Democracy

February 22, 2006

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

The Honorable William Gradison
Acting Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Dear Chairman Cox and Acting Chairman Gradison:

As you know, the Advisory Committee on Smaller Public Companies (ACSPC) released recommendations yesterday that would have the effect of exempting roughly 80 percent of all public companies from the requirement that they have their internal controls tested by an independent audit. We are writing on behalf of the nation's leading consumer organizations to urge you not to publish these recommendations for public comment, as originally planned, since they are in direct conflict with the law, would undermine investor confidence, and do not fulfill the Committee's original charge to "conduct its work with a view to protecting investors." Instead, we urge you to disband the advisory group and to start fresh in your search for ways to minimize the cost of regulatory requirements for smaller public companies while retaining their important investor protections.

1. Investors were shut out of the process.

The ACSPC's work is representative of the worst aspects of regulatory policy-making – where business interests are given privileged ability to influence policy that members of the public, in this case investors, are denied.[1] Although the Commission promised in establishing the Committee that its members would be broadly representative of "the varied interests affected

[1] This is not an isolated incident. Two advisory groups recently appointed by the NASD at the request of the SEC – the Mutual Fund Task Force and the Breakpoint Task Force – offer similar examples of this lack of investor representation on groups that have enormous influence on the policy-making process. Neither task force included any representation for investors, let alone balanced representation. Even the academic selected to participate on both task forces, while widely respected, often works for industry. Both task forces issued recommendations that largely reinforced industry arguments and either ignored investor concerns or dismissed solutions advocated by investor advocates as unworkable. A more thorough historic review of practices in this area would doubtless show that providing meaningful representation for investor advocates – as the PCAOB has on its Standing Advisory Group – is the exception rather than the rule.

by the range of issues to be considered," it failed to fulfill that promise. No representatives of either the major institutional investors or of retail investors were included on the Committee, though they clearly have an urgent interest in the issues to be addressed.

The only Committee member appointed with a credible claim to advocate on behalf of investors – Kurt Schacht, Executive Director of the CFA Centre for Financial Market Integrity – dissented from the Committee's recommendations. As he said at the time:

> "The subcommittee goal was to reduce the cost burdens but maintain the investor protections associated with Section 404. These need not be mutually exclusive. My concern, and the basis for my dissent, is that the panel's recommendations make them mutually exclusive. We seem to say you can't have meaningful cost reductions unless you eliminate 404, including the investor protections."[2]

It is reasonable to assume that, had the Committee been more balanced in its make-up, it could not have gotten away with offering such one-sided recommendations. Instead, it would have been forced to seek a reasonable compromise that addressed the concerns of all affected parties, including investors.

2. The recommendations are in conflict with the law.

Under the ACSPC's recommendations, companies with a market capitalization of less than $100 million and revenue of no more than $125 million would be exempt completely from Section 404 requirements. In addition, companies with a market capitalization of less than $700 million and revenues of no more than $250 million would not be required to have their internal controls tested by an outside, independent auditor. This is clearly in direct conflict with Section 404 of the Sarbanes-Oxley Act, which requires that managers of all public companies (except investment companies) assess and report annually on the adequacies of their internal controls and that auditors annually report on and attest to the accuracy of management's assessment of those controls. The legislation does not give either the SEC or the PCAOB authority to grant the exemptions proposed by ACSPC.

3. Small companies need improved internal controls.

The prevalence of accounting problems among smaller public companies highlights just how ill-advised the ACSPC's recommendations are. The rate of misstatements and restatements among small companies has been found to be much higher than that of large companies – nearly twice as high, according to one study. Small companies also account for a large majority of accounting fraud cases brought by regulators and shareholders. As Mr. Schacht noted in his dissent, "small public companies need checks and balances over financial reporting."

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[2] Statement of Kurt Schacht, CFA, Executive Director, CFA Centre for Financial Market Integrity, before the SEC Advisory Committee on Smaller Public Companies, December 14, 2005.

That smaller companies are particularly prone to accounting problems is unlikely to come as a surprise to anyone who observed the recent meeting of the PCAOB Standing Advisory Group devoted to implementation of Section 404.[3] Although it was almost certainly not their intent, the overwhelming message left by a number of the presentations on compliance challenges smaller companies and their auditors face was that internal controls at many smaller companies are in frighteningly poor condition, that managers are ill-equipped to rectify those deficiencies, and that the small audit firms that audit these companies are ill-prepared to conduct the audits of internal controls required by the new law. Given what we know about the strong correlation between weaknesses in internal controls and the likelihood of a financial restatement, it is only logical that a portion of the market that has widespread short-comings in its internal controls would also be beset by accounting problems.

4. The SEC should start from scratch in its search for ways to reduce Section 404 compliance costs for smaller companies while preserving investor protections.

While the greater prevalence of accounting problems among smaller companies is not surprising, what is surprising is that anyone who is aware of these facts would give any credence to a recommendation that the SEC eliminate the requirement for an independent audit of internal controls at the very companies that are most likely to have serious deficiencies in those controls. In fact, these recommendations would likely be dismissed for exactly what they are – the self-interested pleadings of narrow special interests – were it not for the Committee's standing as an official SEC advisory group. That is why it is so important that the Commission repudiate the Committee's recommendations by setting them aside without publishing them for comment.

To further hammer home the message that investor concerns remain a priority at the Commission, we urge the Commission to formally disband the existing Committee and to pledge that, in order to avoid both the perception and the reality of bias in the policy-making process, all future advisory groups of this type will include balanced representation for investor representatives. This would send a strong message that the Commission is committed to ensuring that investors, and not just business groups, have a meaningful ability to help shape the policies that affect them. That alone could help to boost investor confidence in the fairness and integrity of the marketplace.

Although the ACSPC ignored its charge to suggest methods of reducing the costs of Section 404 compliance while preserving its investor protections, others have given the matter serious thought. The recent op-ed piece by former SEC Chairman Arthur Levitt, Jr. offers a particularly practical and thoughtful approach.[4] We urge you to make this, and not the self-interested recommendations of the ACSPC, the starting point for a meaningful policy discussion about how best to balance costs and benefits of Section 404 for smaller companies.

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[3] Meeting of the PCAOB Standing Advisory Group, June 8-9, 2005.

[4] Arthur Levitt, Jr., "A Misguided Exemption," The Wall Street Journal, January 27, 2006, pg. A8.

5. Conclusion.

Once you start down the road of officially recognizing a second class of public companies subject to weaker corporate governance standards, there will be no end to the requests for new and more expansive exemptions from regulations. The result is likely to be creation of an investing ghetto, where investors venture at their own risk – in this case a ghetto that comprises as much as 80 percent of all public companies. Free market logic suggests that investors will eventually learn to impose a risk premium on companies that fail to adopt adequate corporate governance standards and that the end result will be a higher cost of capital for these companies. That is not in the interest of investors, of the economy as a whole, or even of those who are misguidedly pushing this approach. We urge you not to follow such a path.

Respectfully submitted,

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