R.G. Associates, Inc.
Investment Research/ Investment Management
201 N. Charles Street, Suite 806
Baltimore, MD 21201

Jack T. Ciesielski, CPA, CFA
President

Phone: (410)783-0672
Fax: (410)783-0687

April 3, 2006

Ms. Nancy M. Morris
Federal Advisory Committee Management Officer
100 F Street, N.E.
Washington, DC 20549-9309

Re: File Number 265-23

Dear Ms. Morris,

Thank you for the opportunity to comment on the recommendations of the Advisory Committee on Smaller Public Companies.

Unfortunately, I find their recommendations totally contrary to the interests of investors everywhere - and contrary to the mission of the SEC, if it is to be "the investor's advocate."

The conventional wisdom holds that the costs of Section 404 are disproportionately higher for smaller public firms than for larger firms. Even a cursory review of the comments on the recommendations submitted by small companies provides plenty of anecdotal support for this observation. Yet it should be no surprise that Section 404 is expensive for small firms: the costs of internal controls, including auditing costs, are of a fixed nature. Given that small companies rarely enjoy economies of scale, it's only natural that Section 404 compliance costs will be more of a burden for them.

The other side of the coin is that there are costs for the failure to exercise responsible stewardship over shareholder interests. Maybe internal controls cost shareholders some short term profits; a lack of confidence in published financial statements will cost all investors more in the long run. The entire purpose of the Sarbanes-Oxley Act was to restore investor confidence in financial reporting for all companies - not just companies with a market capitalization greater than $787 million. To exempt 80% of public companies from their responsibility to shareholders is absurd. The recommendations for the "microcap" companies is very nearly the governmental legitimization of a a penny stock market.

The answer is not to simply absolve them of their responsibilities to their shareholders. The answer is to learn from the first year experiences with the law, rather than eviscerating the law. We have seen only one round of Section 404 application in many firms; the second year doesn't seem as bad so far. Judging by coverage by the financial press, there seems to be less bitterness directed towards the Act by firms going through their second year of Section 404 reviews. There's a good chance that the "learning curve" principle still applies: firms can get better at a task as they're given more experience with it.

There's no reason that smaller firms shouldn't go down a learning curve as well. In the long run, all fixed costs - including auditor fees - are variable. Managers of small cap companies are still accountable to their shareholders, who are the beneficiaries of healthy internal controls, and they should seek internal controls that provide assurance that financial information is reasonably reliable at a reasonable cost.

There is no shortage of irony in the committee's recommendations. The committee attempted to find relief for small companies from the internal control provisions of the Sarbanes-Oxley Act as if this was a new responsibility for them. One needs to ask how firms were complying with the internal control provisions of the Foreign Corrupt Practices Act of 1977 before they were responsible for complying with Sarbanes-Oxley's Section 404. There's nothing inherently new about the Sarbanes-Oxley requirements; firms have long been required to impose a system of adequately functioning internal controls.

The Act imposted its requirements on *all* firms in order to invigorate confidence in the markets. A great many of the companies that are covered by the committee's recommended exemptions came public during the 1990's - a period when underwriting standards were fairly lax and markets were not particularly discriminating. You'd have to wonder if these companies would have been able to come public at all in underwriting eras that showed more restraint. You have to wonder why they deserve to be afforded relief from laws that require them to build a control infrastructure that will help insure they will be able to grow bigger without financial implosion.

If they do not wish to meet the standards imposed by the Sarbanes-Oxley Act, there are alternatives to these companies. They can manage the costs, a task which they clearly seem to be avoiding. (Avoiding, that is, unless they consider legislative appeal to somehow be considered "managing.") They can sell out to bigger companies. Or they can go private. There is no natural corporate right for a firm to be publicly-traded; if firms don't want the burdens that go with being able to tap rich public markets, they've got a basic cost-benefit calculus to consider. The public interests are served better by having high standards that act as a filter for weak firms. Capitalism is survival of the fittest; lowering the bar, as this proposal does, permits the weak to survive.

Further evidence of the need for strong internal controls in smaller companies can be found in the recent report on restatements by Glass, Lewis &Co.[1] The need to restate financial statements is an indication that a firm's financial reporting internal controls are lacking. As the report indicates, 59% of the restatements occurring in 2005 related to companies that met the committee's recommendation for exemption. The restatement evidence clearly demonstrates that these are exactly the kinds of firms in need of more robust internal controls - not less examination of their internal controls.

Finally, I am troubled by the legal grounds for an SEC action to exempt companies from provisions of the Sarbanes-Oxley Act. You may be aware of a recent letter to Chairman Cox from a group of law professors which addressed this very issue. (Copy attached). It was the opinion of the professors that Section 404 the Sarbanes-Oxley Act was embedded into the Securities Exchange Act of 1934, and therefore, changes to Section 404 are not within the legal purview of the SEC.

In summary, I strongly urge the Commission to reject the recommendations of the Advisory Committee and to work constructively with registrants and their auditors to make the existing provisions work to the favor of all investors in smaller public companies. If you have any questions or care to discuss these comments further, please call me at (410)783-0672.

Sincerely,

Jack Ciesielski

Jack Ciesielski
jciesielski@accountingobserver.com

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[1]"Getting It Wrong the First Time," Glass Lewis & Co., LLC, March 2, 2006.

DUKE LAW

Duke University School of Law
Box 90360
Durham, North Carolina 27708

James D. Cox
Brainerd Currie Professor of Law

Telephone (919) 613-7056
Facsimile (919) 668-0995
E-mail: cox@law.duke.edu

March 21, 2006

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Response to SEC Release 33-8666 Seeking Comments on the Exposure Draft of the Final Report of the Advisory Committee on Small Business

Dear Chairman Cox:

I, and the many law professors who appear on the attached co-signers' page, join in this letter to express our deep reservations regarding the legal authority of the Securities and Exchange Commission to exempt "micro-cap" registrants from the provisions of section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). The proposed exemption appears in the draft report of the SEC's Advisory Committee on Smaller Public Companies and, pursuant to the definition set forth in the draft, the exemption would remove nearly eighty percent of all U.S. public companies from the requirements of section 404.

As law professors whose research and teaching focus on securities regulations, we have examined the permissible scope of the SEC's authority to promulgate exemptions pursuant to section 36(a) of the Securities Exchange Act of 1934. It is our opinion that section 36(a) of the Securities Exchange Act, or for that matter section 3(a) of Sarbanes-Oxley, does not empower the SEC to exempt issuers from section 404 of Sarbanes-Oxley.

Our conclusion is compelled by the below underscored language of section 36(a):

> [T]he Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person . . . or any class or classes of persons . . . from any provision or provisions <u>of this title</u> or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The expression "of this title" refers to Title I of the Exchange Act. Thus, section 36(a) does not reach other securities law statutes that are within the SEC's jurisdiction, for example the Public

Utility Holding Company Act of 1935, the Investment Company Act of 1940 or the Investment Advisers Act of 1940. Because section 404 of Sarbanes-Oxley is not part of the Exchange Act, it falls outside section 36(a). This conclusion is supported by the committee report accompanying the enactment of the National Securities Markets Improvement Act of 1996 which explains the exemptive authority being provided in both section 28 of the Securities Act and section 36(a) to the Securities Exchange Act as applying only to the provisions of their respective titles.

> "This section adds a new Section 28 to the Securities Act to provide the Commission with the authority, by rule or by regulation, to conditionally or unconditionally exempt any person, security, or transaction, or any class of the same, from any provision or provisions of the Act or any rule or regulation thereunder. . . . The legislation adds a new Section 36 to the Exchange Act to provide the Commission with authority under the Exchange Act similar to that contained in new Section 28 of the Securities Act." *See* H.R. Rep. 104-622, 1996 U.S.C.C.A.N. 3877, at 3900-01

The conclusion that "of this title" refers only to the Securities Exchange Act is further supported by this same expression appearing in section 28 of the Securities Act, section 6(c) of the Investment Company Act, and section 206A of the Investment Advisors Act. Thus, each of these major acts expressly authorize the SEC to establish exemptions but only for "any provision or provisions of this title." When each of these sections are considered, the inescapable conclusion is that none of them provide authority for the SEC to create exemptions other than from the provisions of the particular act whose exemptive authority the SEC has invoked for that exemption.

The Congress, by not imbedding section 404 of Sarbanes-Oxley in the Exchange Act as it did with so many of its other Sarbanes-Oxley provisions, thereby chose to remove section 404 from the SEC's authority to exempt reporting companies from the requirements of section 404. The exclusion of section 404 from the Exchange Act is particularly revealing in view that Exchange Act Section 13(b)(2)(B) mandates that reporting companies "devise and maintain a system of internal accounting controls. . ." If Congress had desired section 404's requirements to be subject to Exchange Act qualification or exemptions that the SEC can adopt pursuant to section 36(a) of the Exchange Act, the natural step for Congress to have taken when enacting section 404 was to cast it as an amendment to Section 13(b)(2). Congress did not do this.

The conclusion that Congress intended all reporting issuers to be subject to section 404, and therefore beyond the power of the SEC to adopt exemptions under section 36(a) of the Exchange Act, is further supported by the language of section 404 which requires that the SEC "prescribe rules requiring each annual report" of a reporting company include assessment by management of internal controls as well as the independent auditor's attestation of management's assessment. Congress certainly envisioned that management's assessment and the auditor's attestation would occur for "each annual report" of reporting companies. Hence, a broad exemption, in addition to being outside the powers the SEC has under section 36(a) of the Exchange Act would also be inconsistent with Congress' clear intent in adopting section 404. Given this conclusion, we also do not believe that section 3(a) of Sarbanes-Oxley can reasonably be read to provide such authority.

The preceding analysis does not mean, however, that the SEC and PCAOB are without authority to tailor section 404 requirements differently for smaller issuers. Sarbanes-Oxley does not authorize the SEC to grant exemptions from its provisions. Instead Sarbanes-Oxley in section 3(a) of Sarbanes-Oxley requires the SEC to promulgate rules and regulations "in furtherance of this Act" that are "in the public interest or for the protection of investors." Specific disclosure requirements tailored to unique risks and likely regulatory benefits of specific classes of registrants are entirely appropriate and consistent with the rulemaking authority the SEC enjoys under section 3(a) of Sarbanes-Oxley.

We believe a far wiser course for the SEC and the PCAOB is to closely evaluate the reporting risks associated with internal controls of various issuer classes and develop an appropriate framework for section 404 compliance by smaller public companies. In making this evaluation the SEC and the PCAOB should understand that there is abundant empirical evidence that financial reporting violations most frequently involve companies whose market capitalization does not exceed $250 million. This approach is far more consistent with the SEC's overall mission than if it were to grant a sweeping exemption, which we believe is unlawful, of nearly eighty percent of reporting companies from any internal control assessment by its senior management and attestation by the firm's auditors.

Respectfully yours,

James D. Cox
Brainerd Currie Professor of Law

cc: Paul A. Atkins, Commissioner
Roel C. Campos, Commisssioner
Cynthia A. Glassman, Commissioner
Annette L. Nazareth, Commissioner

Co-Signers of Letters

Jeffrey D. Bauman
Professor of Law
Georgetown University Law Center

Rutheford B. Campbell, Jr.
Law Alumni Professor of Law
University of Kentucky College of Law

John C. Coffee, Jr.
Adolf A. Berle Professor of law
Columbia University School of Law

Stuart R. Cohn
Gerald A. Sohn Research Scholar
Levin College of Law, University of Florida

Roger J. Dennis
Professor of Law and Provost
Rutgers, State University of New Jersey, Camden

Jill E. Fisch
Alpin J. Cameron Professor of Law
Fordham Law School

Theresa A. Gabaldon
Professor of Law & Carville Dickinson Benson Research Professor of Law
School of Law, George Washington University

Mitu Gulati
Professor of Law
School of Law, Duke University

Thomas Lee Hazen
Cary C. Boshamer Distinguished Professor
School of Law, University of North Carolina

Robert W. Hillman
Fair Business Practices Chair and Distinguished Professor
School of Law, University of California, Davis

Lyman Johnson
Robert O. Bentley Professor of Law
Washington and Lee Law School

Therese H, Maynard
Professor and Leo T. O'Brien Fellow
Loyola Law School, Los Angeles

Alan Palmiter
Professor of Law
Wake Forest School of Law

Frank Partnoy
Professor of Law
University of San Diego School of Law

Margaret V. Sachs
Robert Cotton Alston Professor of Law
University of Georgia School of Law

Mark A. Sargent
Dean and Professor of Law
Villanova University School of Law

Marc I. Steinberg
Rupert & Lillian Radford Professor of Law
Southern Methodist University Dedman School of Law

Steve Thel
Wormser Professor of Law
Fordham Law School

Randall S. Thomas
John S. Beasley Professor of Law and Business
Vanderbilt University Law School