COMMITTEE ON CAPITAL MARKETS REGULATION
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February 26, 2007

Ms. Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-9303

Re: Comments on Proposed Interpretation and Proposed Rule, Management's Report on Internal Control over Financial Reporting, Release Nos. 33-8762; 34-54976
File No. S7-24-06

Dear Ms. Morris:

The Committee on Capital Markets Regulation (the "Committee") appreciates this opportunity to comment on a proposal by the Securities and Exchange Commission (the "Commission" or "SEC") relating to the guidance for company management in its evaluation of internal control over financial reporting.

The Committee is independent and bipartisan, composed of twenty-two corporate and financial leaders drawn from the investor community, business, finance, law, accounting, and academia. The Committee issued its Interim Report on the state of the U.S. public equity capital market on November 30, 2006. The Committee's purpose is to explore a range of issues related to maintaining and improving the competitiveness of U.S. capital markets. As stated in its Interim Report, the Committee believes that maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low cost of capital, innovation, entrepreneurship, and a strong tax base.

The loss of U.S. public market competitiveness compared to other major markets worldwide results from a number of factors: foreign markets have closed the technology gap and narrowed the confidence and liquidity gaps that traditionally favored the U.S. market. Clearly, regulation and litigation play central roles in protecting investors and the efficient functioning of our capital markets, particularly in light of recent, highly-publicized abuses. Yet excessive regulation, problematic implementation, and unwarranted litigation—particularly when occurring simultaneously—make the U.S. capital markets less attractive and, therefore, less competitive with other financial centers around the world. Enhancing shareholder rights and reducing overlyburdensome regulation and litigation are the twin pillars of the recommendations released by this Committee in November.

In the late 1990s, the U.S. exchange-listed capital markets were attracting forty-eight percent of the value of all global initial public offerings ("IPOs"). By 2006, U.S. market share had fallen to 7.2 percent. If U.S. investors are to have access to a vibrant U.S. IPO market and all the protections it affords, then U.S. regulators must work to reverse this trend.

Our report also documents the tremendous growth in private equity capital and going-private transactions—which deprive public investors of access to a growing share of U.S. equity investments. One of the reasons for the increasing attractiveness of private equity markets is concern over the costs of going or remaining public. Since 2001, the number of venture capital ("VC") backed acquisition exits with disclosed values has exceeded the number of VC-backed IPO exits by more than ten-to-one (1919 to 171), with a difference of value of $95 billion as compared to $12 billion, albeit that IPO exits, unlike private exits, typically involve the sale of only a portion of the company.

The Committee believes that Section 404 has provided significant benefits to both investors and business by increasing the reliability of financial statements, strengthening internal controls, improving the efficiency of business operations, and helping to reduce the risk of fraud. The Committee strongly supports the need for effective internal controls. However, the Committee also believes that this objective can be achieved at much lower overall cost than the average cost per company during the first year (approximately $4.4 million) and second year ($3.8 million) of SOX implementation, as reported by the Financial Executives International (FEI) in its cost survey of 2006. It is especially important to reduce management costs, as these costs are the most significant and can account for 70-75% of the total costs of SOX 404.

We commend the Commission for many features of its proposals and support its coordination with the proposals of the Public Company Accounting Oversight Board (PCAOB), Release No. 2006-007, December 19, 2006. Both sets of proposals aim to improve the efficiency and effectiveness of internal controls. In particular, we support the top-down, risk-based approach that allows for the exercise of management judgment in tailoring its evaluation to the company's individual circumstances. We also support allowing management and its auditor to have different testing approaches, only requiring the auditor to express a single opinion on the effectiveness of a company's controls rather than deliver separate opinions on management's assessment process and the effectiveness of a company's controls.

We also believe, however, that the Commission's revised guidance on materiality is the most important issue affecting the cost of Section 404(b) implementation and must be considerably strengthened if SOX costs are to be significantly decreased. Under current guidance, a material weakness is defined as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We support the Commission's proposal to replace this standard with a requirement that there be a "reasonable possibility" that a misstatement could result in a material misstatement. Nevertheless, we believe the Commission should go farther in clarifying the definition of materiality.

There is no reason to examine internal controls that, even if deficient, could have no material impact on the financial statements of the company. Unfortunately, this appears to be happening today. As the Committee's report shows (Figure V.3, p. 123), based on an analysis by Mercer Oliver Wyman of the 2006 GAO study, fifty-three percent of the restatements between 2002-05 had either a negligible negative (less than one percent) or a positive impact on company market value.

The Committee has recommended that materiality for internal control reviews should be defined consistently with the definition of materiality in financial reporting. Specifically, the Committee recommends that materiality for scoping an assessment should be defined, as it was traditionally, in terms of a five percent pre-tax income threshold. This standard would be consistent with the overall risk-based approach taken by the Commission in its proposal. In cases where the five percent test would not be meaningful, the Commission should allow companies to exercise their reasoned judgment in choosing other measures to evaluate materiality in ways that are relevant to investors. We also believe that this standard should be applied to annual, rather than interim, financial statements.

In addition, in the context of lower risk areas, the Committee supports the ability of management to use evidence from on-going monitoring controls rather than be subjected to a requirement to perform direct testing in such areas. On the other hand, critical and higher risk areas should ordinarily require direct testing by management on a yearly basis. The Commission could follow the approach adopted by the PCAOB in its parallel proposals by permitting management to use "walkthroughs" for low-risk controls that have been previously tested. It is essential for both the Commission and the Board to rely on management's and the auditor's well-reasoned judgment in determining both low- and high-risk areas.

The Committee further recommends that the Commission continue to defer the application of Section 404 to non-accelerated filers ("small companies") until the changes it adopts as a result of this proposal take effect for larger companies and the costs and benefits of the revised system are assessed for small companies. This will require the Commission to collect better and more complete information generally relating to the costs of Section 404.

We suggest that the Commission refrain from applying Section 404 to foreign firms that are able to demonstrate that they are subject to equivalent home-country internal controls regulation. While this may presently represent a null set, adoption of this principle is important. The PCAOB currently follows this approach with respect to supervising foreign auditors. The Committee also recommends that Section 404 not be applied to U.S. GAAP reconciliation, contrary to what the Commission currently proposes. Failures in U.S. GAAP reconciliations may result in less accurate disclosure to investors—for which companies are already exposed to substantial liability—but they do not increase the risk of financial losses.

Finally, with only three years of experience, the fact base relating to Section 404 implementation is still fairly limited. As a result, we believe the SEC and PCAOB should continue to collect better and more complete information relating to the costs and benefits of Section 404.

The Committee's Interim Report may be accessed through its website at http://capmktsreg.org/research.html. Specific references to SOX 404 may be found on pages 19-21 and 115-135 of the Interim Report. If the SEC staff should have any questions or comments concerning this submission, please do not hesitate to call Hal S. Scott (617-495-4590) at your convenience.

Sincerely,

Hal S. Scott
Director
Committee on Capital Markets Regulation