Consumer Federation of America

October 27, 2009

Protect Investors in Small and Mid-Size Public Companies
Vote NO on Garrett-Maloney and Adler Amendments to Roll Back Sarbanes-Oxley Reforms

Dear House Financial Services Committee Member:

We understand that two amendments are likely to be offered during today's mark-up of the Investor Protection Act to roll back reforms adopted in the wake of the last major financial crisis. At a time when the Committee is focused on reducing risks to the financial system, both amendments throw open the door to "old-fashioned" accounting fraud by eliminating or weakening the requirement that small and mid-size public companies have effective controls to prevent accounting fraud and that an independent auditor attest to the effectiveness of those controls. Specifically:

- Congressman Garrett and Congresswoman Maloney are expected to offer an amendment to grant the smallest public companies, those with market capitalizations of less than $75 million, a permanent exemption from the requirement.

- Congressman Adler is expected to offer an amendment that would further delay implementation of the requirement for the smallest public companies, and rescind implementation for mid-size companies, until the Securities and Exchange Commission can once again revise the rules to lower the requirements for these companies.

We are writing to urge you to vote NO on these unnecessary, anti-investor amendments for the following reasons.

1) The amendments would undermine essential investor protection.

Numerous studies have shown that smaller companies have weaker controls over financial reporting, poorer quality financial reporting, and a higher incidence of both accounting fraud and accounting errors than larger companies. As a 2009 White Paper by consulting firm Lord & Benoit noted: "While the press focuses on ills of larger public companies, smaller public companies garner little to no attention at all. In fact, weak controls, poor management and occurrences of fraud are more likely in this segment than in larger public companies due to the fact that from both an audit and regulatory perspective, little consideration is given." The higher incidence of accounting fraud at smaller companies is attributable in part to the ease with which

CEOs and CFOs of smaller companies can circumvent the control environment. For these reasons, these companies are arguably most in need of having an outside set of eyes examine their internal control system.

Congressman Adler, whose amendment covers the majority of public companies, argues in an email seeking support for the amendment that we needn't be concerned about weakening fraud protections at small and mid-size companies, because they do not pose a systemic threat. Victims of accounting fraud, however, are likely to take little comfort from the fact that the fraud that cost them their hard-earned savings did no meaningful damage to the broader economy.

2) The amendments are unnecessary.

Both amendments are premised on a false assumption that the costs of SOX 404 compliance for small and mid-size companies are excessive. In fact, the costs of compliance for these companies are quite reasonable. A 2008 study by Lord & Benoit that looked at actual compliance costs at 29 small companies found costs that averaged just $78,474. Moreover, it found that the average cost of complying with both 404(a) and 404(b) was just 0.3% of market capitalization and 0.8% of revenues. That is hardly excessive, particularly when weighed against the benefits. Small companies, which have had nearly eight years to prepare, have every reason to expect a smooth transition, avoiding the bumps that increased initial implementation costs at large and mid-size companies. Meanwhile, mid-size companies, those with market capitalization between $75 and $700 million, have been successfully operating under the requirements for five years.

In defending his amendment, Congressman Adler makes repeated references to the "one size fits all" regulations that have stifled economic growth. These statements mischaracterize both the regulations and their economic effects. In fact, both the SEC rules and the PCAOB audit standards were extensively revised in 2007 to make the requirements scalable based on company size and risk characteristics and generally less prescriptive. At the time, investor advocates warned that the SEC revisions, in particular, risked going too far in elevating concerns about costs over concerns about effectiveness. While only time will tell whether those concerns are justified, early results clearly show the revisions dramatically reduced compliance costs. The recently released SEC study found that costs, already dropping before the 2007 revisions, have fallen even more precipitously (by 29 percent over two years on average) since those changes were made.

3) The amendments are harmful to smaller companies.

Far from benefitting small and mid-sized companies, they allow them to avoid taking steps that would ultimately prove beneficial to them and their investors. Earlier research, which unfortunately has not been updated, showed that control deficiencies and restatements had begun to tail off at 404-compliant companies by 2006. In contrast, restatements were continuing to skyrocket at smaller companies. Given the heavy costs associated with restatements, companies that give short shrift to internal control reforms are being penny wise and pound foolish. Similarly, a study by MIT Sloan Assistant Professor Ryan LaFond found that, "Far from just adding to corporate costs, our findings tell a very different but consistent story about Sarbanes-

Oxley. Firms with strong internal controls already in place and firms that remediate prior control weaknesses are rewarded with a significantly lower cost of capital," which falls by as much as 150 basis points for firms that can demonstrate such compliance. Investors also report greater confidence and willingness to invest in companies that can demonstrate that they maintain strong controls to prevent fraud.

Investors have waited nearly eight years for the reforms adopted in the wake of the last major financial scandal to be fully implemented. Now, as we suffer the devastation of yet another financial scandal, is no time to be rolling back those reforms. Vote to protect investors and promote healthy economic growth: vote NO on the Adler and Garrett-Maloney amendments.

Respectfully submitted,

Barbara Roper
Director of Investor Protection