THE 10TH ANNIVERSARY OF THE SARBANES-OXLEY ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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U.S. HOUSE OF REPRESENTATIVES

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THE 10TH ANNIVERSARY OF THE SARBANES-OXLEY ACT

Thursday, July 26, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:36 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Biggert, Hensarling, Campbell, Pearce, Posey, Fitzpatrick, Hayworth, Hurt, Dold; Waters, Sherman, Lynch, Maloney, Himes, and Green.

Chairman GARRETT. Good morning, everyone. The Subcommittee on Capital Markets and Government Sponsored Enterprises will come to order. Today's subcommittee hearing is entitled, "The 10th Anniversary of the Sarbanes-Oxley Act." Normally, you think of anniversaries are good things. After we hear from this panel today, we will see how amused we should be about this anniversary.

First, we are going to handle a couple of housekeeping items. We have a lengthy series of votes on the Floor that we have been advised of beginning as early as 10:30, so in order to accommodate all of the members of our panel, it has been agreed to by us and the Minority that all Members' opening statements that we normally would give are going to be waived at this point as far as reading them, and they are going to be submitted for the record.

In addition, the Minority has also agreed with us that—I guess you guys know this already, unfortunately—your opening statements have also been shortened from 5 minutes down to 3 minutes.

For us up here, I advise the Members that I am going to strictly enforce the 5-minute rule. So if you have questions, make sure your questions get asked and answered within your 5 minutes so that we can go onto the next person's questions.

Finally, it is my intention that we will release the panel and release the committee at the call to votes. Hopefully, the votes will go a little bit late. But when the votes are called, we have to go.

So, thank you, everyone, for your accommodations. With that, I thank the entire panel for being here with us today. And we will start, as we always do, on the left hand side of our panel.

Welcome. And for those of you who have not been here before, you have 3 minutes, not 5 minutes. As always, we ask you to please bring the microphone as close to you as you can because some of us cannot hear you up here if you do not speak into the microphone.

Mr. Berlau, welcome, and you are recognized for just 3 minutes. And thank you very much for coming to the panel today.

STATEMENT OF JOHN BERLAU, SENIOR FELLOW, FINANCE AND ACCESS TO CAPITAL, THE COMPETITIVE ENTERPRISE INSTITUTE (CEI)

Mr. BERLAU. Thank you, Chairman Garrett. And thank you, Ranking Member Waters and all the honorable members of this subcommittee for inviting me here to testify on behalf of my organization, the Competitive Enterprise Institute, a think tank founded in 1984 that fights and advocates and educates about freedom and opportunity for investors, entrepreneurs, and the economy as a whole.

And I must say I agree with you, Mr. Chairman, that on past anniversaries there really was not much for investors and entrepreneurs, with Sarbanes-Oxley and the way its provisions had been implemented, to celebrate. As the Obama Administration's Council on Jobs and Competitiveness recognized in a recent report, "well-intentioned regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on a large number of smaller companies."

And it made the connection and fingered Sarbanes-Oxley, or SOX, as a culprit in the long-term decline in IPOs, something that happened long before the recession in the first few years after SOX's passage—you can even look at the number of IPOs lower in the boom years after SOX than in the early years that were slow growth years of the 1990s—and made the connection between IPOs and job growth.

But actually, on this anniversary we do have a little bit to celebrate because this House, virtually all the members of this subcommittee, and President Obama have enacted into law the Jumpstart Our Business Startups Act, and we are already seeing that pay dividends for investors, entrepreneurs, and the economy as a whole.

The JOBS Act creates an on-ramp that among other things exempts newly public companies for their first 5 years from the internal control mandates of Section 404. And we are already seeing well-respected companies list under the JOBS Act such as Kayak, last week—the travel booking site—and Five Below, the teen retail discounter, which had very successful IPOs that are trading above their share price in contrast to the Facebook IPO, which was not subject to the JOBS Act; it was too large.

So, we are seeing—we have already seen, I have in an appendix, 46 companies that are listing here because of the JOBS Act. They are designating themselves as emerging growth companies under the law. I think that is evidence that SOX was choking off IPOs both the sheer number and actually smaller IPOs. But there is more we can do. And H.R. 6161 would keep a small company in revenues and profits from being designated as large just because of market volatility as a large company.

Thank you, and I am happy to answer any questions.

[The prepared statement of Mr. Berlau can be found on page 55 of the appendix.]

Chairman GARRETT. And thank you for your testimony.

Mr. Bullard, welcome to the family. And you are recognized for 3 minutes.

STATEMENT OF MERCER E. BULLARD, PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC., AND JESSIE D. PUCKETT, JR., LECTURER AND ASSOCIATE PROFESSOR OF LAW, THE UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

Mr. BULLARD. Thank you, Chairman Garrett. Thank you, Ranking Member Waters, and members of the subcommittee for the opportunity to appear before you today on the anniversary of Sarbanes-Oxley. It is an honor and a privilege to appear before the committee again today.

Before addressing the Act itself, it is worth revisiting the bipartisan context in which it was enacted. House and Senate votes in favor of Sarbanes-Oxley totaled 522, with only 3 votes cast against.

This is remarkable in view of the major reforms the Act entailed, in particular, the creation of an entirely new regulatory entity, the PCAOB, that has become a leading force in the regulation of public accounting both in the United States and abroad. Some provisions have generated controversy, however. For example, Section 404 has been criticized for imposing excessive costs on issuers.

In my view, this criticism is substantially misplaced. The cost of compliance derives not from Section 404 itself, which imposes very generic monitoring requirements. Rather, compliance costs derive from the implementation of Section 404 by regulators. And this is where any changes should be made.

Nonetheless, Congress has granted wholesale exemptions from Section 404, which I believe are inconsistent with the very concept of a public company, which really has meaning only if public companies are subject to a consistent set of default rules. This problem would be exacerbated by the Fostering Innovation Act, which would make existing Section 404 exemptions essentially swallow the rule.

In conclusion, I would like to address four other areas of concern relating to Sarbanes Oxley.

First, PCAOB Chairman Doty has rightfully argued that PCAOB disciplinary proceedings should not be conducted in secret. It is not appropriate to ask issuers' audit committees to choose their auditors with care, while depriving them of information about alleged auditor misconduct. Congress should amend Sarbanes-Oxley to require that PCAOB proceedings be public, as SEC proceedings against auditors have been for 25 years.

Second, I encourage Congress not to adapt a statutory prohibition against mandatory auditor rotations. The PCAOB should be afforded the deference due to an expert regulator to make findings and adopt rules in this area as appropriate.

Third, Congress should amend the whistle-blowing provision of Sarbanes-Oxley to clarify that disclosing the misconduct of public companies will be protected, even when the whistleblower is employed by a private company. The SEC, the Department of Labor, and numerous DOL arbitrations have all agreed with this view, but a divided First Circuit panel has taken the opposite position. The court's holding allows a public company to neutralize the whistleblowing provision simply by hiring a nonpublic accountant or other entity to conduct its compliance activities.

Finally, Congress should inquire into companies' compliance with a requirement to report executive stock option grants within 2 days. This requirement has been instrumental in preventing the options backdating that was pervasive prior to 2002. But research shows that backdating persists because up to a quarter of option grants are being reported in violation of the 2-day requirement.

Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you may have.

[The prepared statement of Professor Bullard can be found on page 61 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Coffee, good morning, and welcome to the panel.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

Mr. COFFEE. Good morning. Thank you, Chairman Garrett, and members of the subcommittee. I am happy to be here for the 10th anniversary of SOX.

I will start with this general observation: Since SOX was enacted, there has been a robust debate, indeed an intellectual war between those who argue that the declining competitive position of U.S. capital markets was caused by overregulation, an alleged avalanche of overregulation; and the other side, which says that investors basically have lost confidence in U.S. capital markets both because of a host of scandals and because of underregulation, as overworked and underfunded regulatory agencies have failed repeatedly.

In the abstract, I think both sides can be right, and can score points. And I will agree that there has been, at times, significant overregulation.

Nonetheless, we look at our current vantage point on the 10th anniversary. I must tell you that the greatest obstacle to stronger capital markets and better access for smaller issuers to the equity capital market is not overregulation, but it is the loss of investor confidence.

When you look at what is causing investor confidence to decline, we can start with the original Internet bubble back in 2001, when investors saw that securities analysts were conflicted and that accountants were often compromised. Sarbanes-Oxley tried to address that. But since then, we have seen a host of very recent scandals that have to have an impact on investor confidence.

Investors are seeing over and over again that underfunded, overworked regulators cannot catch real crooks, and they only slap them on the wrist when they do catch them. We have all just seen the Peregrine Financial and MF Global scandals, and frankly it is hard to understand why a rational investor would put money into a commodities account with a commodities broker when no one seems to know whether the customer funds had been segregated from the funds placed at risk by proprietary trading.

That scam at Peregrine Financial was a 20-year Ponzi scheme that went undetected. We are now watching the Libor scandal. Not only does it show us what we already know, that creators will often manipulate markets, but that regulators can be very cozy and very equivocal in their response.

I could go through a number of similar examples. But my point is again that in the wake of the JOBS Act, where we have deregulated the market for emerging growth companies, which I understand. They are given a 5-year transitional period.

The step now being contemplated is that we are going to let companies that are not emerging and not growth companies, they are rather companies that I would call mature mediocrities, get a permanent exemption from Section 404. The SEC has studied this problem and the SEC has found that compliance with Section 404 greatly reduces the rate of financial restatements. Thus, I would suggest that the case for exempting mature mediocrities has not yet been made.

My time is up. Thank you.

[The prepared statement of Professor Coffee can be found on page 82 of the appendix.]

Chairman GARRETT. Thank you very much.

Mr. Gallagher, welcome to the panel. And you, too, are recognized for 3 minutes. Thank you.

STATEMENT OF MICHAEL J. GALLAGHER, CHAIRMAN, PROFESSIONAL PRACTICE EXECUTIVE COMMITTEE, CENTER FOR AUDIT QUALITY (CAQ)

Mr. GALLAGHER. Thank you, Mr. Chairman. Mr. Chairman, Ranking Member Waters, and members of the subcommittee, my name is Mike Gallagher and I am pleased to testify today on behalf of the U.S. auditing profession regarding the Sarbanes-Oxley Act of 2002. I have more than 26 years of experience in public accounting. I am currently the chairman of the Professional Practice Executive Committee, or PPEC, of the Center for Audit Quality. I am also the managing partner of PwC's audit quality functions. I am speaking today with you in my capacity as the PPEC chairman.

In examining Sarbanes-Oxley, let us go back to where we were 10 years ago and the reason the Act was passed. The markets were roiled by a series of massive financial reporting frauds, including Enron and WorldCom. The fraudulent and materially misstated financial information reported by these companies drove their stock price up to levels that were completely unsupported by economics or their business performance.

When the frauds were ultimately exposed, investor reaction was swift and decisive. Both companies failed in sudden and dramatic ways, causing a loss of investor confidence more broadly across the capital markets.

To restore investor confidence and enhance protection, Congress responded in a near unanimous and bipartisan fashion by passing the Sarbanes-Oxley Act. The House vote was 423–3, and the Senate vote was 99–0. President Bush signed the bill into law, ushering in a new era of reforms that improve the integrity of financial reporting.

In sharp contrast, the business failures during the more recent financial crisis resulted from sudden and extreme economic events, most notably the seizing of liquidity, which caused certain companies to fail.

So let me briefly highlight some of the significant provisions of the Sarbanes-Oxley Act. The Act strengthened audit committees. It empowered them to more effectively carry out their responsibilities. It made management clearly responsible for the financial statements, enhancing accountability for financial reporting. And auditing was improved through the creation of the PCAOB and strengthening independence rules.

Now, the changes I described certainly came with costs. However, these costs generally have declined significantly over the last 10 years due to company and auditor efficiencies as well as actions taken by the PCAOB and the SEC. The Dodd-Frank and JOBS Act also provided certain exemptions and further relief.

So, in bringing this to a close, unfortunately when the public hears about financial reporting, the new is never good. It is about the restatement, the material control weakness or the business failure.

In my position, I get to see the other side, the positives of Sarbanes-Oxley, almost every day. The restatement that was avoided because of a key internal control; the disclosure that was improved due to a great dialogue between the audit committee, the management, and the auditor; and the fraud that was identified early because of higher-quality auditing. These successes are not public, and they do not make news. The benefits of Sarbanes-Oxley are substantial. And in my view, it is serving the capital markets and investors very well.

Thank you. And I am happy to answer any questions you may have.

[The prepared statement of Mr. Gallagher can be found on page 93 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

At this time, before we go to Mr. Hatfield, I believe Mr. Fitzpatrick would like to make an introduction. And before I do that, I will just say I wish to thank the gentleman for his efforts in this area and your legislation as well.

Mr. FITZPATRICK. Thank you, Mr. Chairman. I would like to introduce Mr. Jeffrey Hatfield with Vitae, an emerging biotech firm in Montgomery County, Pennsylvania. We welcome you today to the committee. Thank you, sir.

Chairman GARRETT. Thank you.

The gentleman is recognized for 3 minutes. Mr. Hatfield?

STATEMENT OF JEFFREY S. HATFIELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, VITAE PHARMACEUTICALS, ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

Mr. HATFIELD. Thank you. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Jeff Hatfield. I am the president and CEO of Vitae Pharmaceuticals, as mentioned, in Fort Washington, Pennsylvania. I want to thank you for the opportunity to speak today about the unique hurdles the biotech industry faces in its quest to discover, develop, and deliver to patients important new cures for diseases that plague those patients.

Now, in finding an important balance between regulations that protect investors and regulatory burdens that stifle growth, the key is speeding breakthrough discoveries to people who desperately need them. Delivering new treatments to patients is difficult. It takes biotech more than a decade to research and over a billion dollars on average to bring novel treatments to people living with disease.

This very long development effort is undertaken without any product revenue to pay for the tremendous costs. Biotech companies instead rely entirely on external investors to fund our research. Because investment dollars go directly from the investor to the lab, any funds devoted outside that R&D effort are by definition lost to scientific innovation.

Biotechs are simple organizations. The overwhelming majority have less than 100 employees located in the same building and no product revenue. At Vitae, for example, my CFO personally reviews the documentation for and signs every check that we issue. I do the same for any check over $5,000. That is how capital-efficient our investors expect us to be.

And yet if we went public, we would have to dedicate upwards of a million dollars annually to comply with requirements for internal controls for financial reporting. That is almost $20,000 per scientist at Vitae for compliance with Section 404(b) as it exists. Without product revenue, those funds would come directly from investors, damaging the conversion of their capital from science to compliance.

Alternatively, I think about the 2010 congressional grant initiative called the Therapeutic Discovery Project. Vitae applied for and was fortunate to receive last year research grants totaling around $900,000. We used that to hire scientists to advance our work. If we were public, we would have had to in essence turn that money over to an accounting firm for auditors. It is very clear to me which choice our investors prefer.

I support investor protection. In the biotech industry, an informed investor is a good one. If the information disclosures required by SOX do not align with information my investors most want and need—we put our historical financial reports and the meeting materials for every board meeting; I had one yesterday.

Rarely, if ever, in the 8 years I have been CEO, have we discussed the historic financial numbers. What the investors focus on and want to know in great detail is about the science that we generate. Investors make their decisions about companies based on scientific milestones, not statements and reports mandated by Section 404(b).

The cost of compliance far outweighs its benefits. If Congress can relax this regulatory burden on small companies like those found in the biotech industry, it will allow innovators and entrepreneurs to continue working towards delivering the next generation of medical breakthroughs which can someday day cure the patients who need them. Thank you.

[The prepared statement of Mr. Hatfield can be found on page 108 of the appendix.]

Chairman GARRETT. And I thank you for that. Thank you, Mr. Hatfield.

Ms. Hollein, welcome. And you are recognized for 3 minutes.

STATEMENT OF MARIE N. HOLLEIN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL EXECUTIVES INTERNATIONAL (FEI)

Ms. HOLLEIN. Thank you. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am pleased to testify before you concerning the Sarbanes Oxley Act and its impact on Financial Executives International. FEI is a professional organization of 15,000 senior financial executives for more than 8,000 private and public companies.

Integrity is the necessary first principle for effective markets, and an important part of FEI's mission. Every investor depends on accurate and reliable financial reporting. Without the trust that comes with market integrity and sound corporate governance, investors withdraw, capital markets wither, companies cannot grow, and jobs become scarce.

Ten years ago, Congress passed Sarbanes-Oxley to restore integrity to a tarnished market. Now, we have an opportunity to examine what has worked and how we might do better.

During the SOX debate, FEI offered several recommendations which were eventually adopted into the legislation, one of which resulted in the requirement that a company's CEO and CFO certify the firm's financial statement.

The requirement that CEOs and CFOs must personally certify their company's financial statements is the crown jewel of Sarbanes-Oxley. This sets the tone from the top, increases the accountability and drives better corporate governance.

After its passage, even SOX supporters acknowledged portions were costly, time-consuming, and overly prescriptive. FEI's 2005 survey on SOX implementation showed a 66% increase in external consulting costs and a 58% increase in auditor fees. In 2011, fees continued to rise, but at a slower 5% average rate.

While FEI does not yet have a position on H.R. 6161, offered by Congressman Fitzpatrick, a number of our member benefit companies would benefit from the increase in reporting flexibility it provides.

As we consider new laws, regulations are not the only path to better markets. FEI is stepping up to the plate to research, improve, and share best practices in deterring and detecting fraud through its work as a bonding member of COSO and the Anti-Fraud Collaboration.

Thank you for the opportunity to address you this morning. And I look forward to your questions.

[The prepared statement of Ms. Hollein can be found on page 115 of the appendix.]

Chairman GARRETT. Great. Thank you.

We will now begin the questions. I am going to defer to the gentleman with the legislation that so many of you have been speaking about this morning.

Mr. Fitzpatrick is recognized for 5 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Mr. Berlau, one of the main goals of this Sarbanes-Oxley Act, now 10 years old, was to protect investors. In your view, has the Act protected investors or protected as it was intended?

Mr. BERLAU. No. It has not. Its costs are very high, and its benefits are hard to quantify. We have seen companies fully subject to SOX audits like Lehman Brothers and MF Global have scandals and mismanagement.

And I think the best quote on the lack of benefits came from Hal Scott of Harvard University who said that it remains empirically unclear whether adherence to SOX 404 achieves its intended benefit. What is often cited are the increasing number of restatements—but Professor Scott makes clear that some of those may be due to technicalities and the market prices have not really reflected these were large misstatements that Sarbanes-Oxley detected.

Mr. FITZPATRICK. So, did Sarbanes-Oxley help to prevent the financial crisis in 2008?

Mr. BERLAU. It did not. In fact, it may have hurt.

The lack of IPOs may have shifted more investment than would have otherwise occurred into real estate. It certainly kept the focus away of companies expanding and building a profitable firm. All of these technicalities, like keeping track of office keys and some of the other things accounting firms counted as internal controls, may have compromised companies' focus on risk management.

Mr. FITZPATRICK. Professor Bullard, in your statement, I think you indicated on the subject of audit firm rotation that you are in favor of the mandatory rotation rule that is currently being considered or being developed. That would be an expansion of Sarbanes-Oxley. Is that accurate?

Mr. BULLARD. I am sorry if my testimony was not clear. It is not that I support it. I am somewhat skeptical of whether mandatory rotation would be beneficial. But in reviewing the PCAOB's review of this issue, and their extensive requests for information from the business community, I think they are handling it wisely. And I think it would be better to leave them the flexibility to find the right approach.

Mr. FITZPATRICK. Do you think that PCAOB should engage in a cost-benefit analysis as a condition to going forward on the rule, to see what the actual cost is?

Mr. BULLARD. Yes, it should.

Mr. FITZPATRICK. Mr. Hatfield, the high costs associated with Sarbanes-Oxley Section 404(b) compliance has been listed repeatedly by small and emerging companies as one of the deterrents from listing in the U.S. public markets. Would you agree that it is not only the real dollar cost of compliance, but also the opportunity cost that is an issue?

Mr. HATFIELD. Absolutely. The financial costs obviously are daunting for a company that is putting every investment dollar toward clients. The cost for developing breakthrough medicines or cures for people is daunting. Every dollar needs to go to that science. Every dollar that does not go there detracts from the ability to advance those cures. I would say that it is coming short, the opportunity costs, in a couple of ways.

When the science does not get done, then people living with those diseases do not get the cures. And I think that is the most significant opportunity costs. If we are taking it away, we are taking it away from scientists, and giving it to the fulfillment of compliance.

And people living with chronic kidney disease, with diabetes, with Alzheimer's, all the things we work on, how can we tell them that we did not get them the cure, but we are compliant with regulations? I think that is tough to say.

The opportunity costs over a billion dollars to be able to develop these medicines. Investors want protection, but they want protection to make sure the science gets done. That is why they put the dollars in.

They are not investing for dividends. They are not investing for revenue growth. They are investing to deliver these cures. And I think that is the most important focus. If we are not doing that, we are not doing our jobs.

Mr. FITZPATRICK. So, what are you hearing from investors, perhaps your investors, about the cost of your entity to comply with Section 404?

Mr. HATFIELD. I just had a board meeting with our investors yesterday, talked to them about coming here and talking to the subcommittee. And their direction to me—these are the investors speaking—was to go get rid of that regulatory burden because we want to get to science.

The fact of the matter is that complying with Section 404(b) has been for years the number one discussion point in boards as we think about going public. That is the number one drain, the reason not to do it. Private companies' CEOs feel that it is not worth it to go public, often because of the burden. And CEOs say we do not want to go—public CEOs say we should go private because it detracts from what we intend to do.

Chairman GARRETT. Thank you for your time. The gentleman yields back. Thank you.

The gentlelady from California is recognized for 5 minutes.

Ms. WATERS. Mr. Chairman, I have a question for Mr. John Berlau.

The Dodd-Frank Wall Street Reform Act permanently exempted companies with the public float of less than $75 million from Sarbanes-Oxley Section 404, which effectively exempted 60 percent of all public companies.

In addition to that, Congress also passed the JOBS Act, which would exempt newly public companies. What additional percentage of companies would be exempt if the Fitzpatrick bill became law, and if the Congress keeps passing additional exemptions? Does Sarbanes-Oxley become meaningless at some point?

Mr. BERLAU. Congresswoman Waters, thank you for the question. And thank you for your support of the JOBS Act.

Ms. WATERS. You do not have to tell everybody.

Mr. BERLAU. Okay.

[laughter].

I do not know what percentage of—I can get back to you on that. I think Congressman Fitzpatrick's bill is important because say there were a biotech company like Mr. Hatfield's and all of a sudden there were an FDA approval or a sign of good work or something.

The company is taking in no new revenues or new profits. But its—a stock price could shoot up. And all of a sudden, even though the assets, the profits or the revenues have not changed, the company could be classified as a large company. And then, it could have all these additional costs, and it is just trying to develop its product again and create jobs. So, I think that is why reclassifying what public float and market cap is, and using another measure, is important.

Ms. WATERS. Mr. Coffee, what do you say to that?

Mr. COFFEE. I would tell you we are talking right now about basically taking 1,000 companies outside of the range of having Section 404(b) compliance. The SEC elaborately studied this a year ago, and the SEC reported that companies that are compliant with Section 404(b) have a rate of restatements that is 46 percent lower than the rate of companies that are not compliant.

If you take 1,000 companies, and say there is a 46 percent difference in the rate of restatements, that is an awful lot of fraud. And I think it is going to make investors quite nervous about that kind of change.

Moreover, it is not just the 1,000 companies that are in this zone between $75 million and $250 million. The way the statute has been written, any company that has under $100 million in revenues, even though it might have a market cap or a public float of $690 million, would be exempt.

So, I think you are giving a very large exemption, permanently, not for 5 years the way the JOBS Act does. And I think the SEC is right to say the case has not been made for that large an exemption.

Ms. WATERS. Mr. Bullard, do you agree with Mr. Coffee's analysis of Mr. Fitzpatrick's bill?

Mr. BULLARD. Yes, I do agree. But I would like to sort of bifurcate it. There is the point about what should be the standards that should apply. And I agree with Professor Coffee that the standards should be the existing Section 404(b) standard.

But I would also like to add that the current approach to exemptions is essentially not taking issue with the standards as applied by regulators; it is essentially saying there should not be a requirement for management assessment or evaluation. There should not be any audit or attestation.

The efficient way to approach this, especially for those who are interested in cost-benefit concerns, should be for regulators to decide what the right level is, not to grant wholesale exemptions that essentially make absolutely meaningless the idea of a public company for regulatory purposes.

The issue here really should be regulatory oversight. It should not be the very fundamental protections that I have not heard any particular objection to, that are in Section 404(b) itself.

Ms. WATERS. Thank you very much.

Mr. Berlau, you had the first word on this. I have heard from Mr. Bullard and Mr. Coffee. Do you have a rebuttal?

Mr. BERLAU. Yes. I think that this lets investors decide how much internal controls are worth to them. And I think you are seeing a lot of investor interest in Kayak, the travel site, and Five

Below, the discount teen retailer—I had to ask my intern what that was.

And really one of the criticisms of the internal control requirements is it has been defined as things like office keys, in some cases, or the number of letters in employee passwords; things that are not exactly relevant to good corporate governance and risk management. So, it is letting the public as investors decide how much these internal controls are worth, while still policing and protecting from fraud. That's what the JOBS Act and Mr. Fitzpatrick's bill would do.

Chairman GARRETT. I thank the gentleman. And the gentlelady yields back.

Mr. Schweikert is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

First off, a fundamental issue, and I would love first an explanation from the panelists and tell me if you see something other than I do. I look at the aggregate data of the last decade. And yes, there has been some—a bit of a financial rollercoaster through there.

But even when you adjust for 2008, what happened to IPOs, after the SOX mechanic, what happened to the U.S. IPO market, particularly in juxtaposition to what was happening in other places around the world?

When I look at aggregate data today, there is literally one third fewer publicly traded companies today than there were a decade ago. So, this is one step off saying okay, the disclosures, the protections that were designed in SOX may be absolutely appropriate and justified.

Something happened in our U.S. capital markets. And first, I would like to start with the professor. What happened, and is there a linkage?

Mr. BULLARD. There are academics with more expertise on that. My survey at least is there are a lot of explanations. Probably the principal one is that other countries just got a lot better at attracting that kind of business, as they have with respect to a lot of areas of commerce. But I will leave it to Professor Coffee, who has a lot more expertise in this area.

Mr. SCHWEIKERT. My friend to the left?

Mr. BERLAU. Yes. There—certainly there has been a long—the data shows there has been a long-term decline. There is disagreement about the causes although I would say the return of some after the JOBS Act would argue that Sarbanes-Oxley was a big cause of that.

But there were fewer IPOs, for instance in 2006, a relatively good year for economic growth, an expansion year, than there were in 1991 when we were coming out of recession, fewer absolute numbers. There has been a debate in the economic literature that IPOs might actually be countercyclical. And that as debt is closed off people will issue more equity, so we do not have this tool to help us come out of the recession.

Mr. SCHWEIKERT. Mr. Coffee?

Mr. COFFEE. Basically, and I do study IPOs, what issuers are looking for is not an IPO, but to raise capital by the least-costly means. And beginning in the period of around 1998, private placement became a much cheaper means of raising capital.

Mr. SCHWEIKERT. But doesn't that make the point that private placement became less expensive than going public? And for some reason, going public got much more expensive in capital formation?

Mr. COFFEE. The first thing I would tell you is that public offerings became much more difficult after the Internet bubble burst. A tremendous amount of money was lost and people would not go back to the people who sold them Pets.com. Investors learned a very harsh lesson—

Mr. SCHWEIKERT. But your comment is that the same investors then would go through private equity.

Mr. COFFEE. No. I am saying, first, private placement, which is often debt and sometimes equity became much cheaper and much easier to raise.

Second, smaller issuers simply cannot do IPOs under any structure because large institutional investors, who are the principal purchasers in public offerings, want high liquidity. What we are seeing is that to the extent we have public offerings today, they are in the $500 million range because that is what institutional investors demand.

I would suggest that things like—

Mr. SCHWEIKERT. We can get back to that point, because in my minute-and-a-half, you may have hit on something I am heading for.

Mr. Gallagher?

Mr. GALLAGHER. Thank you, Congressman.

As was said before, there are so many reasons. You cannot isolate one specific reason for the change in IPOs during that period. It is very dynamic for multiple reasons including the availability of capital.

But I would also say during that period between 2006–2007, the requirements and how Section 404(b) in particular was implemented after that time period have been much more efficient because of some standard setting changes and the way the auditing profession and the way the companies are dealing with Section 404(b).

Mr. SCHWEIKERT. Ms. Hollein?

Ms. HOLLEIN. Yes. First of all, our membership is more than 50 percent private companies. And there are a variety of reasons for the increased number of companies that are choosing to remain privately owned rather than go public, partly because of the regulatory reporting and the internal control requirements with which public companies must comply. But an additional difference would be in the tax treatment that has motivated many of these companies to remain private.

Mr. SCHWEIKERT. Okay. And you do understand—I do not know if you all were listening to each other. The cross-messaging we get is that Sarbanes-Oxley raised costs. It was the availability of capital. But everyone moved over to private placements and—so the money was over here, but it was not over here so it could not have been choking off of capital because they found the money over here. We got a mixing of messages.

What is the—

Chairman GARRETT. Sorry. The gentleman's time has expired.

Mr. SCHWEIKERT. And we missed the punch line. Thank you, Mr. Chairman.

Chairman GARRETT. We will come back to the punch line.

The gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman.

First of all, I want to thank all the witnesses. I want to especially thank you for your thoughtful testimony. It has been varied, but I think in all cases it has been very astute and thoughtful.

I would like to focus, Mr. Bullard, Mr. Coffee and Mr. Gallagher, on the proposal to rotate the auditors. Mr. Bullard, you have gone agnostic on this, I guess. But there are a couple of factors.

One is it is rather arbitrary to say every 5 years, for instance, we are going to require a company to change auditors and bring in a new company. There are some cost factors with that. Obviously if a company is auditing year-to-year, there is a certain efficiency that is gained by the familiarity with the way that company works. But there is the integrity factor that auditors are not being captured by the client.

So, if you would, Mr. Bullard, Mr. Coffee, and especially Mr. Gallagher because of your position, I would like to have your thoughts on that, the cost and the efficacy of actually rotating auditors.

Mr. BULLARD. I will be very brief. My main concern was that Congress not prevent the PCAOB from finding the right solution. And a statutory prohibition would place into doubt whether the PCAOB could take an alternative approach such as having a presumption that the audit relationship at the end after 10 years, and that the board had to do something to overcome that. Or that there would be some kind of mandatory disclosure or findings made by the board.

If Congress acts in this respect, those alternative approaches come into question as to whether the PCAOB would have that authority. So, audits themselves, I think even the investor community has some ambivalence about whether this is the right way to go. But I see a great deal of thought given to this by the PCAOB. My main point would be to let the experts decide the question.

Mr. LYNCH. Very good. Thank you.

Mr. Coffee?

Mr. COFFEE. I am going to give you a very equivocal answer after all that. I am not able to endorse the idea yet of mandatory rotation of the firm. We do rotate the auditing partner. And there are other countries that are now requiring mandatory firm rotation. I would like to see what their experience is.

I do think this has to be given a thorough cost-benefit study. And I believe that the PCAOB—and I serve on one of its advisory boards—would not do this without a very thorough study because they will be subject to judicial review. So, I do not think this is about to happen.

Mr. LYNCH. Okay. Fair enough. Thank you.

Mr. Gallagher?

Mr. GALLAGHER. Congressman, my view is that audit committees are in a very good position to make a decision based on the specific facts and circumstances that exist at a particular company about how to select the auditor and mandatory firm rotation would limit the audit committee's ability to make that judgment. Who is in the best position, as opposed to a one-size-fits-all solution, I think is a better way to go in terms of quality.

There has never been any linkage between tenure and negative impacts of audit quality. In fact, if anything, history tells us otherwise.

But that said, I do agree with Mr. Bullard that I think this is appropriately dealt with at the PCAOB. I think the process has been a good one. And I think you wind up at the right answer.

Mr. LYNCH. Thank you. I have a minute-and-a-half left.

Ms. Hollein, you mentioned in your testimony that you considered that the crown jewel of Sarbanes-Oxley was the fact that we have the CEOs and CFOs sign off on financials after the first district's decision that said that on a whistle-blower case, a nonpublic company would not be bound by allegation or attestations that they made.

Do you think that we should also require nonpublic contractors to these companies to also be bound by the same penalties and prohibitions that we place on the CEOs and CFOs? In other words, if I hire a nonpublic accountant, they are not bound by the same restrictions that we placed on those subject to Section 404, for example on Sarbanes-Oxley. Have you given any thought to that? I know that you sort of mention it in your remarks.

Ms. HOLLEIN. Yes. We do feel—just looking at it we actually studied more of the public company sectors of our membership more than the private companies related to the Whistleblower Act. We do feel, however, that the CFOs and CEOs having signed off on it has provided a more robust process within the terms. And this would also possibly benefit the private companies, although we would have to study that further to see what the burden would be on those individual companies.

Mr. LYNCH. Okay. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from Texas, Mr. Hensarling, is recognized for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Berlau, in your testimony, you advocate repeal of Section 404 of Sarbanes-Oxley. You say essentially it does not meet the cost-benefit test.

And I think, Mr. Coffee, you used the same phrase. I want to let you know how welcome the phrase "cost-benefit" is in this committee room. We rarely hear it uttered.

On the cost side, Mr. Berlau, I guess you allude to SEC data that cites an average cost of compliance with Section 404 of $2.3 million. I think, Mr. Hatfield, you said the average compliance for a biotech company was about $1 million. So, I am trying to focus somewhat on the cost side of the equation.

There has been some discussion. I would like to study it a little bit more carefully. We know that there have certainly been fewer IPOs and that the IPOs we have had post-SOX have been larger. So, we can certainly have a debate about the cause and effect of that.

Mr. Berlau, you also refer to the fact that—I guess you quote Bernie Marcus, the co-founder of Home Depot, who apparently has been quoted publicly on a number of occasions saying that he never could have taken Home Depot public had Sarbanes-Oxley been in effect when Home Depot was launched.

So, again, I am trying to isolate the various costs that we have, not just direct cost to the companies. But there is obviously an opportunity cost for average retail investors who might have missed out on the next Home Depot.

Can you elaborate on other costs that you see with respect to Sarbanes-Oxley? And particularly the cost of perhaps channeling some of these start-ups or emerging growth companies to private placements and debt as opposed to public equity?

Mr. BERLAU. Yes. I think this is what the Facebook IPO and the flaws in that, the after effects demonstrate that maybe it was just too big to succeed.

When Home Depot went public in the pre-SOX era, it had just four stores to its name. It used the money from going public to build hundreds of stores and employ the 300,000 people it does now. Whereas, in contrast, when Facebook went public, it was already a household name and some of these other things. And it was—and its IPO was $100 billion, and less than that as the share price has gone down.

So I really think this shows how retail investors, ordinary investors cannot get in on a Home Depot at its growth stages or a Starbucks or a Cisco Systems. It all went public when they were relatively small.

And the good news is that already with the JOBS Act, with just the 5-year exemption, we are seeing companies like ClearSign Combustion, a green technology company out of Seattle that has a $20 million market cap IPO. I do not think we have seen one this small since before Sarbanes-Oxley.

So, the SEC still says—although some costs have come down slightly—Section 404 is 7 times as costly for a smaller company as in a larger company, and for its investors as well.

Mr. HENSARLING. Mr. Bullard, in listening to your testimony, if I heard you properly, you did not find fault with Section 404. You found fault with the implementation of Section 404. And I thought I heard you say that you essentially believe that the regulators have it wrong and the cost could be much lower. Did I hear you properly? And if so, can you elaborate?

Mr. BULLARD. I did say the first part, but not necessarily the second. I think that the history shows that regulators have conceded they probably got it wrong with respect to the first implementation of Section 404(b), and that is essentially the audit standards issued by the PCAOB.

Today, what we have seen is the SEC economists have found that there have been declining costs. The PCAOB has substantially revised the requirements under Audit Standard 5. And I think that is the appropriate way for this to proceed. I do not think anyone—

Mr. HENSARLING. If I could, I see my time is running out. I want to try to slip in one more question.

Mr. Berlau quoted Professor Scott of Harvard Law School who says that it remains empirically unclear whether adherence to SOX

404 achieves its intended benefit. Mr. Gallagher, you spoke of some of the benefits that you perceive. But just how empirical are these benefits versus anecdotal?

Mr. GALLAGHER. Congressman, I think if you look at the intended purpose of SOX in terms of financial reporting, and the fact that restatements went down after it worked itself through the system and the internal controls got significantly better, identified the issues that were there prior to the implementation. Restatements have gone down significantly, and I think that is a tribute to the benefits of SOX.

Chairman GARRETT. Thank you.

Mrs. Maloney is recognized for 5 minutes.

Mrs. MALONEY. Thank you for calling this hearing. It is an important one. And I thank all of the panelists here today.

I truly do believe that markets run more on trust than on capital. You see it all the time. And I believe we have to remember why Sarbanes-Oxley was created in the first place. It was to restore trust. Some of our most respected companies that were rated AAA plus, crashed in 24 hours, wiping out jobs, wiping out pensions, 401(k)'s, devastating communities in which they were located. And it was a horror.

And I got phone calls. I believe probably everybody on this panel did, calling upon us to restore confidence. And it was legal, a lot of things. It was legal to hide tremendous losses and lack of capital. So, in a bipartisan way, Sarbanes-Oxley was passed and put into law.

I would like to ask Mr. Bullard and Mr. Coffee—and I have to mention that Mr. Coffee is from the great State of New York and teaches at one of our very important institutions. We welcome you today. Thank you for your service and for being here.

But were we successful on our primary goal of restoring confidence? We would have done nothing if there had not been a crash. We would not have done it. We would not have moved. But there was a problem, an accounting scandal. So, we worked to address it.

So, Mr. Coffee, since you are from my home State, if you would respond first, and then Mr. Bullard, from the great State of Mississippi. I am so glad you are here. Thank you.

Mr. COFFEE. I agree with what you were saying. Investors pay a price based on how they perceive the risk and return. If they think the risk of fraud is high, they will pay a lower price. And thus, companies will find capital much more expensive.

The number of IPOs has never recovered from the Internet bubble in 2000–2001. And there is also this large impact of Enron, WorldCom, and the series of accounting scandals.

Did SOX thoroughly cure the problem? Probably not, but thoroughly curing the problem would be extraordinarily expensive. So, SOX was a partial step in the right direction.

The SEC studied this in response to Dodd-Frank, which they asked them to study what further exemptions should be done from Section 404. And they felt that Section 404(b) was working, and that giving a broader exemption would produce a lot more fraud. The case has not been made.

I am not in a better position than the SEC to disagree with them. There will be debates, continuing debates about the costs and benefits of Section 404. But you are quite right. It is intangible. Do investors trust companies? And I would say the series of scandals that we have seen recently, including the ongoing Libor scandal, makes them distrust not only companies, but the adequacy of regulatory oversight.

Mrs. MALONEY. Mr. Bullard?

Mr. BULLARD. I agree very much with Professor Coffee's statements. And I would add that one of the issues, as Sarbanes-Oxley has matured over time, has not necessarily been problems with the statute in and of itself.

We very rarely hear somebody criticizing SOX and then actually referring to the terms of the statute. What you see is criticism with respect to implementation. And as Chairman Garrett has been particularly sensitive to, part of this is an issue of the SEC's historic problems with doing cost-benefit analysis.

But I think we need to recognize it is in a revolutionary period, hiring many more economists as we speak. And that what we need to keep sight of is the appropriate structure of administrative law as something can actually operate efficiently. And it cannot operate efficiently with micromanagement at the congressional level. We need the SEC to evolve as it has—as it currently is in the cost-benefit frontier.

Mrs. MALONEY. Very briefly, I would like to follow up on Professor Coffee's statement on the SEC study, and I invite anyone to respond to it, that the amount now at $75 million exemption. And many of us in fact even had a bill at one point from $50 million exemption.

Dodd-Frank had the $75 million at 60 percent—covered 60 percent of the companies in America. But the SEC study said that there was no reason to exempt anymore. If you could elaborate on that, or if anyone else would like to mention it.

And as I understand it, the real cost is when you set up the infrastructure and the reporting system. And once you have set that up, then the cost to the companies is not—

Chairman GARRETT. The gentlelady has 30 seconds left for an answer.

Mrs. MALONEY. Mr. Coffee? Do you want to respond?

Mr. COFFEE. I did not want to take all the time. I agree with what you are saying. The cost is front-loaded. The companies who would now be exempted have been complying with Section 404(b) for 5 years or more. And therefore, while they would like to have their costs reduced, they really are—these really are some costs. We are not talking about subjecting new companies to them.

Chairman GARRETT. Thank you.

Mrs. MALONEY. Thank you.

Chairman GARRETT. Mr. Royce is recognized for 5 minutes.

Mr. ROYCE. I think Mr. Coffee has had some insights, some key insights, and I think over the years, some of these insights have been included in legislation.

Your overarching idea of applying the penalty not to the shareholder, but to those officers, those directors who are culpable—you have written about this in the past. You have witnessed in the past years over the subject. That is a key component of Sarbanes-Oxley. And that is one that I think is very effective in terms of those disincentives.

The premise, however, and here is where we get into a question of cause and effect. We can readily agree that the dot-com bubbles and the malfeasance that has occurred in the market have had an impact against IPOs. But when we look at market share, and originally the United States was the majority of IPOs, then we watch it go to 11.5 percent. Then we watch it go to 8.6 percent.

And in the context of IPOs worldwide being rolled out in Europe and Asia, and our market share continues to fail to address amendments to the cost of Section 404(b), especially to those new companies like Mr. Hatfield's. And I want to ask him about this because if you look at the biotech industry, and I read his testimony and—their efforts, expertise, kidney disease, Alzheimer's, how you get a cure for dementia.

What is not seen in all of this is his thesis that money taken away during this on-ramp out there from that type of work and applied to these kinds of costs, which is not a good fit, especially for a biotech company going public. Why can't we look at amending the Act so that we still achieve your overarching goal, Professor Coffee, which is a very good one?

But at least we begin to recognize that besides what you see in front of you there are these unseen costs in terms of his diabetes trials, which you know if there is a cure here we want this to come to market soon. That has to be weighed in the balance. And I think I would ask you about that.

Mr. COFFEE. I agree with what you are saying. But it leads me to believe that you do not want an all-or-nothing approach that says all companies of less than $250 million public float are excluded.

What I think you need, and the person missing from this table is the chairman of the PCAOB, in terms of are there more focused, more surgical ways of reducing these costs with smaller companies?

Mr. ROYCE. Okay—

Mr. COFFEE. And that kind of focuses—

Mr. ROYCE. But I have to let Mr. Hatfield talk for a minute, too.

Mr. Hatfield, could you explain the conundrum here, succinctly?

Mr. HATFIELD. I will try that. But I support many of the provisions of SOX. I think investor protection is really important. The key issue is balance and cost-benefit for that. IPOs are down. And I can cite specific conversations amongst my colleagues in our boardroom that one of the primary reasons for that is bureaucratic burden that takes away from our mission.

Mr. ROYCE. Talk about the IPOs in the biotech sector, because those numbers are impactful.

Mr. HATFIELD. It is terrible. That is one of the most important discussions that are going on in boardrooms, whether or not to take on that burden, whether to divert funds from investors into compliance.

I think the great example of whether or not this really is an issue is what the JOBS Act has done. If I look now at the filings that have occurred since the JOBS Act was enacted—and thank you for that—Biotech ought to be 3 percent. It is 25 percent in the filings now. So obviously, something was relieved, pressure on the system that now allows biotech companies that are trying to create these cures to actually access—

Mr. ROYCE. And other CEOs in your field, what is their reaction to this legislation that we are discussing today in terms of further amending Sarbanes-Oxley?

Mr. HATFIELD. One of the comments that I got—I was talking to somebody who runs a public company. And he said, "Hey Jeff, what I regret about going public is I switched from leading the company to being chief compliance officer. And that really changed my life." So, that is what I would like—balance is important, but right now, Section 404(b) for companies in the biotech industry is a large burden.

Mr. ROYCE. Thank you.

Mr. Chairman, thank you.

Chairman GARRETT. Right. Mr. Himes will have the last 5 minutes. And then, in order to get more people in, we are going to go down to 3-minute questioning.

Mr. Himes?

Mr. HIMES. Thank you, Mr. Chairman.

And thank you to the panel. I have actually found this discussion incredibly interesting. And I think anyone listening to the panel would arrive at the conclusion that yes, regulation does impose costs on companies like Mr. Hatfield's, costs that may or may not be wise, depending on whether they reduce the risk premium that investors would subtract from Mr. Hatfield's business to invest in it.

It is that simple. And I have not heard a single thing from this panel saying that SOX has not actually improved investor protection. And yes, there are costs.

My colleague Jeb Hensarling said that we do not engage in cost-benefit analysis as much as we should, and I could not agree more. And part of the problem is that we can quantify the costs that someone like Mr. Hatfield bears.

We are in disagreement here. Mr. Berlau has $2.3 million. The SEC study says $600,000. We can quantify that. There are 3,500 filers who have to pay Section 404 costs. But the benefit is a little harder to get at. And I want to explore that a little bit.

Mr. Berlau, in your testimony, which I found colorful, and I appreciate that, by the way—

Mr. BERLAU. Thank you.

Mr. HIMES. Your opening metaphor here that we need to liberate to stimulate, that we should think of this as grass that is growing; one does not need to teach or subsidize grass to grow, rather remove the rocks obstructing its growth and it will grow wide and tall. It makes me want to break out in song.

[laughter].

Mr. Berlau, is this the metaphor we should think about that you should frame this debate in? And let me ask you a specific question: Have you ever come across a blade of grass that borrowed money that had shareholders, or that could make a decision to commit fraud?

Mr. BERLAU. I cannot take credit for that metaphor. That was my vice president, Wayne Crews, my boss. That is the way we look at all public policy.

But yes, I think investors and entrepreneurs—it is sort of like a garden. And the question is, people come together and make different arrangements.

But it is the government's role to prevent—to make sure that there is transparency, and there is not fraud. And it is up to the gardeners and all of the different people who take care of the—to come up with—

Mr. HIMES. My question was partly rhetorical. So, let me explore this question of cost-benefit. Thank you for the answer, though. It is hard to get your arms around what the benefits are because we are talking about crises averted. But I am struck by the fact that the numbers and the costs, and I do not in any way not take seriously how expensive a dollar is to a company like Mr. Hatfield's. VCs, angel investors extract a very substantial price for that dollar.

So, do not get me wrong on this. But the costs that we are talking about in this cost-benefit analysis are always in the hundreds of thousands and millions of dollars. Mr. Berlau, you say $2.3 million. The SEC study says $600,000. What about the costs?

Mr. Berlau, what was the peak market capitalization of WorldCom and Enron, those two companies? What was the peak market cap of those two companies?

Mr. BERLAU. Let me say first—

Mr. HIMES. No, a simple question. Please answer it.

Mr. BERLAU. I—

Mr. HIMES. The peak market cap of Enron and WorldCom was $250 billion combined, a quarter of a trillion dollars in value obliterated by fraud.

Now, I am not going to make the argument—I will let the panel make the argument if they want—that SOX is perfect. But I do not need to. Because if I take the 3,500 filers of Section 404 and I use your number of $2 million, I get about $7 billion, a very—

Mr. BERLAU. That is the SEC's number. I can send you the—

Mr. HIMES. Okay. Whatever. I will give you the $2 million. Let us just say $7 billion, because we have 3,500 filers. That is $7 billion, expensive dollars—$250 billion in market cap obliterated in the meltdown which David Schweikert called a little financial rollercoaster, with $17 trillion in U.S. household wealth obliterated. So, can I take some fraction of those numbers and hold those against your $7 billion?

Mr. BERLAU. Sarbanes-Oxley was in effect before the meltdown and it did not seem to do much. The question is, will this achieve its intended benefit? And as Professor Scott of Harvard said, it is unclear that it does.

Mr. SCHWEIKERT. And will the gentleman yield for a second?

Mr. HIMES. No. I am actually—I have 33 seconds, so I am not going to yield.

Do you agree that I can take some fraction of the $250 billion of obliterated market cap of Enron and WorldCom and hold that on the opposite side of the scales of the $7 billion that SOX apparently costs us on Section 404? Is that a fair way to think about it?

Mr. BERLAU. Only if you can show the provision actually affects that and prevents that type of—

Mr. HIMES. Do you believe that Section 404—there are studies that show that it reduces the rate of restatement. Do you believe—

Chairman GARRETT. The gentleman's time has expired.

Mr. HIMES. —that has no effect?

Chairman GARRETT. So, that will be a rhetorical question as well. [laughter].

The gentleman from New Mexico is recognized for 3 minutes.

Mr. SCHWEIKERT. Mr. Chairman, quick parliamentary inquiry.

Chairman GARRETT. Yes?

Mr. SCHWEIKERT. Sarcasm is banned from the committee.

Chairman GARRETT. From this point on.

Mr. SCHWEIKERT. Thank you, sir.

Chairman GARRETT. The gentleman from New Mexico is recognized for 3 minutes.

Mr. PEARCE. I thank the gentleman for lowering the time to 3 minutes just as I start.

Mr. Coffee, you refer to an SEC study in justifying some of your positions about this. And so I guess my question is that this is the same SEC that was sitting in the room when MF Global was transferring money out of segregated accounts, and you want us to sit up here as policymakers and just blithely take that.

And with just 3 minutes, we will probably move on, but—if we will go ahead and look at MF Global, Sarbanes-Oxley was in effect. And wasn't MF Global making trades just a day before the report period came out so that they would understate the amount of actual debt they had in the actual—

Mr. COFFEE. You seem to be describing the Lehman Brothers scam, the repo—

Mr. PEARCE. No. I am talking about MF Global. I am talking about Jon Corzine. I am talking about Jon Corzine who came in here and testified. And yes, they were taking stuff off the balance sheets. And it is in place. And you are quoting the SEC—

Mr. COFFEE. I am certainly not defending MF Global.

Mr. PEARCE. I will tell you when it is your time to speak. You are trying to get—you are trying to say that the SEC is going to be the great protector. And I am telling you they sat in the room and watched MF Global take that money out of segregated accounts. They were watching them as they moved stuff on and off.

Now, Mr. Berlau will tell you that I am not necessarily a great critic of Sarbanes-Oxley. But we are trying to find a balance point here. And when you come in and say, "the SEC, the SEC, the SEC," and we watch from up here what the SEC has done under this law, and we watch what they did in the complete meltdown, the illegal transferring of assets out of segregated accounts. Then, I say that I am not sure the answer is regulation.

Mr. Berlau, they have really brought up good points that the market is about trust. So, you cannot just walk away from that. You cannot walk away from the fact that trust is needed, and things do happen on balance sheets that cause a lack of trust. How do you, in your mind, rectify those two?

Mr. BERLAU. I would certainly agree with that. And before this—MF Global was such a basic failure of rules in place even before

Sarbanes-Oxley. For decades, it was the first rule of thumb that you—

Mr. PEARCE. I just need an answer. Just skip to it. We are really short of time. We have 15 seconds. So—

Mr. BERLAU. I am sorry. Can you repeat the question?

Mr. PEARCE. Yes, trust. How do you find it if you say we should repeal it? How do you find the trust in the market? How do you find the confidence because people have some more—Mr. Himes was asking a very good question.

Mr. BERLAU. Well—

Chairman GARRETT. Okay. I—

Mr. BERLAU. —they are to police fraud and reputation. Reputation is a commodity. Like Warren Buffet, other CEOs have developed.

Mr. PEARCE. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. I thank the gentleman from New Mexico.

The gentlelady from New York, Ms. Hayworth, is recognized for 3 minutes.

Dr. HAYWORTH. And I thank the chairman.

I am going to follow Mr. Himes' query regarding the—and I realize it becomes—

Chairman GARRETT. The gentlelady will suspend.

Can we set the clock for her 3 minutes?

Dr. HAYWORTH. Oh. Thank you.

Following on regarding—and acknowledging that it can be exceedingly difficult, especially from the macro level, to calculate the relative costs and benefits, counterfactuals; obviously, we are all arguing different sides of this.

But when we talk about the relative cost to the economy, Mr. Berlau, would you venture a guess as to the opportunity cost that has been lost as a result of certain more onerous aspects, shall we say, of Sarbanes-Oxley in having a chilling effect on the public offering marketplace? There must be a certain number of trillions involved in that as well or a certain fraction of trillions at least.

Mr. BERLAU. Two numbers are important. Ivy Zhang of the University of Rochester published a paper in which she estimated, as you said, Congresswoman Hayworth, the opportunity costs of companies not listing other things of Sarbanes-Oxley as being as high as $1.4 trillion.

I would also note in the IPO Taskforce organized by the Obama Treasury Department that they said that the cost of the long-term decline in IPOs in terms of jobs lost associated with that would be about—could be as high as 22 million jobs not created in the past—it the past decade or so. And it is—so a lot of the—yes, there are a lot of opportunity costs. And it is hard to measure. But what some of the—even some of the things that have been measured and shown is just quite chilling.

Dr. HAYWORTH. So, it is fair to say that there is probably room for improvement. And I take Mr. Gallagher's comments very seriously, and those of others on the panel, regarding the importance of having accuracy in the representation of financial statements. Obviously, that is a very important aspect.

But, Mr. Hatfield, would you say as an entrepreneur that there is a balance that we can reach and that we can provide a certain amount of liberations like Mr. Berlau says, but also allow for that investor assurance that Mr. Gallagher and Professor Coffee have advocated for?

Mr. HATFIELD. Absolutely. And as previously mentioned, I think there are very strong components of Sarbanes-Oxley that are important. The overall transparency that it creates important Section 404(a) with management responsibility increased impact if they are not. I think those are all very important. And I think where the balance comes in on the other side is Section 404(b) and the costs associated with that.

Importantly, I would just say our investors, and that is what we are talking about here is protecting the investors. And I have heard from them directly and I know what this marketplace is, the biotech companies. The investors want to know about the science. Again, for 8 years now, we have not spent material time in the boardroom on historical financial reports. We are focused on driving science and finding cures for people.

Dr. HAYWORTH. As you should be.

And Mr. Chairman, thank you all. I yield back.

Chairman GARRETT. The gentleman from California is given 10 seconds for coming in so late. No, 3 minutes.

Mr. SHERMAN. Okay. Or when we have to leave for votes, we have to leave for votes.

I think there has been some confusion this morning about the distinction between Sarbanes-Oxley Sections 404(a) and 404(b). Why is the audit required under Section 404(b) important? I do not know which member of the panel? Mr. Coffee?

Mr. COFFEE. Yes. Did you address me? Okay. I think that Section 404(b) requires the auditor to attest to the adequacy of management's internal compliance efforts. Section 404(b) does seem to relate to the percentage of restatements that subject companies experience. The SEC study did find that if you are compliant under Section 404(b), the rate of restatements goes down by something like 46 percent. That is not a small number.

I agree we can debate costs and benefits for a long time. But what I would point out is that in the wake of Sarbanes-Oxley, a number of companies went private. More recent studies have found that even those companies who went private continued to remain reporting companies and to comply with Section 404(b) because debt investors insisted upon it. That suggests that debt investors saw some value in reporting and in Section 404(b).

So, I do think that there is some value to this. And the SEC made many mistakes. But it was not MF Global because the principal regulator of MF Global was the CFTC. So, I want to give credit where credit is due. And that probably belongs to a different agency's failure.

Mr. SHERMAN. I will ask Mr. Gallagher to quickly respond, and then we have to go vote.

Mr. GALLAGHER. Congressman, I think Professor Coffee is dead on. If you look at the numbers and the rigor of the internal control analysis by management, knowing that somebody is going to come in and provide that audit, and provides the assurance to the capital markets. And to Mr. Himes's point, you know the benefit of the cost of capital because of that assurance, because of that confidence in the higher level of rigor of that internal control analysis.

Mr. SHERMAN. So, you would pay more to the accountants and you pay less to your bank.

I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Dold is recognized for 3 minutes.

Mr. DOLD. Thank you, Mr. Chairman, for the 3 minutes that we have. And I certainly want to thank all the panelists for coming.

My colleague from Connecticut was talking about cost-benefit analysis, certainly something that I also agree with. I also want to talk—I do think this is largely about trust.

But I do think that if we—in talking to a number of companies and talking to some public officials, some of the concerns that I have are not just about the lack of IPOs that have been coming, or lack thereof, into the marketplace. But we have actually seen companies de-list from U.S. exchanges to go to other exchanges, whether it be to Ireland or someplace else, because of this over-regulatory burden that is being placed upon these companies. And certainly, that is an enormous concern that I have.

Now, we talked a little bit about the cost-benefit analysis, and certainly when we look at the cost of Enron. But I am not so sure. If we had had Sarbanes-Oxley, if SOX had been in place, Mr. Coffee, would Enron not have happened?

Mr. COFFEE. I cannot tell you that it would not have happened. And I think it is more likely than not that it would have happened.

Mr. DOLD. Okay. And I think that is the point. Good companies are going to do good things. Bad companies certainly are one of those things that we have to be looking out for. Trust is going to be one of those critical things.

So, in terms of that cost-benefit analysis, I am not so sure that my colleague is 100 percent correct in saying all of that would have been saved; there would not have been fraud going on out there because we have things like MF Global that happen. And certainly people are doing bad things and things which are against the law.

And from my opinion, and I think hopefully somebody will be brought to justice. We are also seeing that again the cost of compliance is significantly more expensive as a percentage as Mr. Berlau had talked about for smaller companies and larger companies.

In the last little bit of time that I have, one of the things that I do want to talk about is the mandatory rotation for audit terms. Does anybody really think that if somebody is intending on committing fraud or hiding it, they are not going to hide it from the auditors as well?

And if a Big Four accounting firm, let us just say, were to be caught up in an accounting fraud scandal, does anybody think that would not be devastating to that company? Would any other major Fortune 1000 company use that auditing firm again? Does anybody think that would not be a self-regulated type entity?

Or do we think that the government needs to come in and mandate that no, you have to rotate? Is it 5 years? Is it 7 years? Is it 10 years? Why not 15 years? What is the actual number?

And what my real point is, is the government not weighing in a little bit too deeply here? Because certainly the auditing firms, they absolutely want to make sure that they are following the letter of the law because that is going to be critical for their business model. Because if they are caught up in some sort of a scandal, if they do things wrong and the light is shone upon them, trust me, that is going to be devastating to that firm.

Mr. Coffee, do you want to comment? And then, Mr. Bullard?

Mr. COFFEE. As I said earlier today, I was not endorsing mandatory rotation of firms—

Mr. DOLD. I did not say—

Mr. COFFEE. —and I would point out—

Mr. DOLD. I am asking if you would comment on that quickly—

Mr. COFFEE. I would point out that if you rotate the auditor, that is an opportunity to capture the new auditor. I do not know that you will get a better, stronger auditor when you rotate, because if you are a corrupt CEO, you may go out and solicit the auditor who will be most acquiescent. So, I am not testifying that will be the perfect answer.

Chairman GARRETT. Mrs. Biggert, for 3 minutes or one question.

Mrs. BIGGERT. Thank you. I will try one question, Mr. Chairman.

Ms. Hollein, SOX attempted to improve companies' internal controls and deter fraud. That said, are there comments since private sector initiatives, education efforts or better communication between the PCAOB and audit committees that could be done instead of adding costly regulations?

Ms. HOLLEIN. Yes. I think as the private sector, we have actually stepped up. And we have been in collaboration with the Center for Audit Quality helping to educate. We have done a roadshow with all of our members throughout the Nation just helping to educate them on the deterrence and detection of fraud. And we will continue to provide those types of opportunities and thought leadership to them. In addition, we are part of the COSO framework addressing internal controls and actually refreshing that to detect fraud.

Mrs. BIGGERT. Thank you very much, and I yield back.

Chairman GARRETT. Thanks. Since the gentlelady yields back, I will yield myself 3 minutes for the final word of the day.

So, there are some things that are good with SOX and there are certainly some things that are terrible about it. And there are certainly some things that were good about Dodd-Frank, and certainly some things that were terrible about it. I guess the ironic part of all this is that one of the best parts of Dodd-Frank was the repeal or the lowering of the limits—raising the limits for SOX. So, that is the irony there.

Let us begin with Mr. Hatfield. When these crises occurred back like when Enron and WorldCom and all those things, Congress rushes in, tries to pass legislation to do it right away. One of those people—one of the Senators who helped pass SOX was Jon Corzine, who then went on to become CEO of MF Global. And so the question there is did having him in—having Sarbanes-Oxley in place, did that solve or prevent the losses over there?

Mr. HATFIELD. It would seem to be that they did not. I think regulation has its purpose. But if we are to protect against every outcome and the bad actors that inevitably are going to be out there in some measure, we can increase regulation to the point where no one will ever go public. And public companies, particularly those in the less than $250 million float range that Congressman Fitzpatrick has sponsored legislation on, those companies will go back to being private. And I think we need to establish the balance.

Chairman GARRETT. Right. And so just in line with that, and I know the other side of the aisle believes that Section 404(b), we have talked about that, is the answer to all these things. Without objection—I guess I will not get any objection—I will put into the record the attestation provision from the compliance with that for Lehman Brothers right before their bankruptcy, and also put into the attestation provision from JPMorgan right before their recent London Whale trade.

I will also put into the record the attestation provision for Bear Stearns & Company right before their bailout. Also again, the attestation provision with regard to MF Global right before Jon Corzine as CEO apparently transferred millions of dollars from investors' accounts, customers' accounts. And also, the two attestation provisions, one from Fannie Mae and one from Freddie Mac, right before each one of their bailouts in the past.

Without objection, obviously it is clear that those attestations in compliance with SOX did nothing in all of those circumstances.

Mr. Coffee, in your written testimony, and you just touched on it very briefly; you used the words "mature mediocrities." There we go mediocrities. These are companies that have been in place for about 5 years or more and just sort of stayed about the same.

And whereas we are saying that maybe the small companies, and I think you even said maybe need that growth pattern and the exemption to get up there that these do not. Is there something about companies that want to stay at that level that they do not deserve the same sort of exemption and abilities to continue to grow that the small companies do?

Mr. COFFEE. I think the differences between a brand new startup company that might use a 5-year transitional experience in order to comply with Federal securities laws. That is what the JOBS Act said. And I think that is a stronger rationale than saying a company that has already been subject to Section 404(b) for at least 5 years should get a complete immunity.

And do they want to stay at that level? I assume that all companies would like to get their market capitalization up and their stock price up. But we will see a certain amount of gaming if we use this rigid test of $250 million.

The SEC has made that finding in its report that any time we use a rigid market cap test, we are likely to see a lot of gaming around that key line. And because there are more companies, there will be more gaming.

Chairman GARRETT. Right. And I guess we could see if you go back to what was the impetus behind Sarbanes-Oxley in the first place was not the small companies, was not the mid-size companies; it was not even these mature mediocrity type companies.

It was the huge companies. It was the Enron's. It was the WorldCom's. It was some of the other companies that were literally huge companies that initially was the trigger for Congress to do their typical knee-jerk reaction in these things and pass SOX. And it was not these mid-size companies and was not the small companies.

And the last point, and Mr. Himes is not here, is the costs and the cost-benefit analysis, which is one of my driving home points. And there is really—this is a rhetorical point. While if we can pass legislation and try to do a cost-benefit analysis and say on the one hand is the expense, millions or billions of dollars.

And on the other hand is the entire collapse of the world marketplace. What you are never going to have a reason not to pass legislation to do so because you can never outweigh that. But what is intangible is—and a couple of you talked about this—the opportunity costs.

And the fact that we are seeing so many IPOs going overseas and not going over here—what is that expression: It is priceless.

The businesses that are not in this country, the jobs that are not in this country, the families who have been dislocated because they cannot get a job anymore, the communities that have been decimated because they do not have jobs whether it is in manufacturing, construction, biotech or the like. How do you put a price on that?

That is called opportunity costs. I do not know. The economists probably cannot do it. But that would be the rhetorical question back to Mr. Himes. And that is the question that we have to grapple with in any legislation when we do a price-benefit analysis.

But with that, I have to go vote, hopefully before the board closes.

I ask unanimous consent to make a statement from the Institute of Internal Auditors a part of the record.

Without objection, it is so ordered.

Again, thanks so much to the panel for putting up with the abbreviated portion here. But all your testimony has already been considered and will continue to be considered. I thank the panel.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

The hearing is now adjourned.

[Whereupon, at 11:00 a.m., the hearing was adjourned.]

A P P E N D I X

July 26, 2012

FOR IMMEDIATE RELEASE
July 26, 2012

Contact: Amy Smith
Phone: 202-225-4465

Garrett Opening Statement at Hearing Regarding the 10th Anniversary of the Sarbanes-Oxley Act

WASHINGTON, DC – Rep. Scott Garrett (R-NJ), Chairman of the Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises, issued the following opening statement today at a hearing regarding the 10th anniversary of the Sarbanes-Oxley Act:

"Today's hearing will examine the Sarbanes-Oxley corporate governance law, 10 years after it was signed into law.

"Sarbanes-Oxley (SOX) was passed in 2002 in the wake of the accounting failures and frauds at Enron and WorldCom. While these scandals were terrible and many investors lost their life savings, Congress did what it normally does – pass a law claiming to have solved all of the problems and that it will never happen again.

"Sound like a familiar story? It should. The passage of Sarbanes-Oxley no more solved all of the potential problems with financial reporting and corporate governance than Dodd-Frank did with Too-Big-To-Fail. What each law did is lay on another huge layer of cost on our economy and one-size-fits-all red tape over our small businesses and job creators.

"My colleagues across the aisle claim that if we just pass one more law, add one more regulation, take away one more freedom; that all of the problems in our financial sector will go away, investors will only gain money and never lose and that there will be no more fraud or bad actors anymore. Unfortunately, this is just not true.

"One of the most hotly contested provisions of Sarbanes-Oxley is 404b, the requirement that public companies have an outside, independent attestation of their internal controls. My friends on the other side and their investor group allies claim this is a vital and important requirement that adds immense protection for investors.

"Well, I would like to enter into the record the following independent attestations for internal controls for the following companies:

Lehman Brothers – right before their bankruptcy
JP Morgan – right before their recent London Whale trade
Bear Stearns Co. – right before their bailout

MF Global – right before Jon Corzine illegally transferred millions of customer funds into his own account
Fannie Mae – right before their bailout, and
Freddie Mac – right before theirs

"404b didn't prevent investors from losing any money with these firms. It didn't even slow it down. I would like to thank the gentleman from Pennsylvania, Mr. Fitzpatrick, for his recently introduced legislation that would narrow the definition of an accelerated filer and exempt more small businesses from this onerous requirement. I commend him for his hard work.

"I am not saying all of the parts of Sarbanes-Oxley are terrible or don't have some benefit. Nor am I saying that of Dodd-Frank, but I do find it ironic that one of the best parts of Dodd-Frank is a provision added to exempt small businesses from Sarbanes-Oxley.

"And, as difficult as Sarbanes-Oxley has been for small businesses to comply with, Dodd-Frank will seem like SOX on steroids. Just the corporate governance provisions in Dodd-Frank: (Say-on-Pay, Proxy Access, Pay-Ratio, Claw back, Conflict Minerals, and Extractive Industries) will have a more negative impact on small public companies and job creators than the entire SOX legislation has had.

"In the current economic environment where unemployment is chronically above 8% and our job creators face the very real threat of higher taxes and additional regulation, it is essential that we conduct appropriate oversight on all federal statutes regardless of whether they have been around 10 years or 2 years.

"I thank the witnesses for their participation today and look forward to their testimony."

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OPENING STATEMENT
CHAIRMAN BACHUS
Subcommittee on Capital Markets and Government Sponsored Enterprises
"The 10th Anniversary of the Sarbanes-Oxley Act"
July 26, 2012

Thank you, Chairman Garrett, for convening this hearing to review the first decade of the Sarbanes-Oxley Act and its impact on the U.S. economy and the capital markets.

When Congress passed the Sarbanes-Oxley Act in response to the accounting and corporate governance scandals at Enron, WorldCom and several other large corporations, it did so to promote greater transparency in financial reporting, increase accountability in boardrooms, protect investors, and promote sound corporate governance. While there are many good provisions in Sarbanes-Oxley that helped restore confidence in the U.S. capital markets, the costs associated with the law are significant. It is incumbent upon this Committee to continually assess whether the costs of this law – and any financial services law – exceed the benefits and whether changes are necessary to ensure that compliance costs do not disadvantage small companies.

Several studies indicate that a majority of public companies believe the cost of complying with Sarbanes-Oxley exceeds the benefits in the first year. Moreover, at a time when fewer companies are going public in the United States, companies consistently identify Sarbanes-Oxley compliance as a deterrent to accessing the public markets. This Committee has already taken action through the JOBS Act to help remedy this situation, and we must be willing to take more action if necessary.

There are also concerns about regulatory overreach brought about by Sarbanes-Oxley, particularly with the Public Company Accounting Oversight Board that was created by the Act. For example, the Board ignored the flexibility provided to it in the Dodd-Frank Act to scale its oversight of auditors of broker-dealers. Instead, the board imposed a one-size-fits-all exam program on all of these auditing firms. Moreover, there are some at the PCAOB who believe that public companies should be required to rotate their audit firms. Mandatory audit firm rotation is not sound policy and would increase both the cost of auditing and decrease audit quality.

In closing, I want to thank Congressman Fitzpatrick for introducing legislation to refine the SEC's definition of a large accelerated filer. In this struggling economy, Congress should do everything it can to make it easier for small businesses to grow, create jobs and, ultimately, sell shares to the public. Congress should always be willing to consider proposals that foster the formation of capital or relieve some of the regulatory burdens that impede the formation of capital, the extension of credit and the creation of jobs.

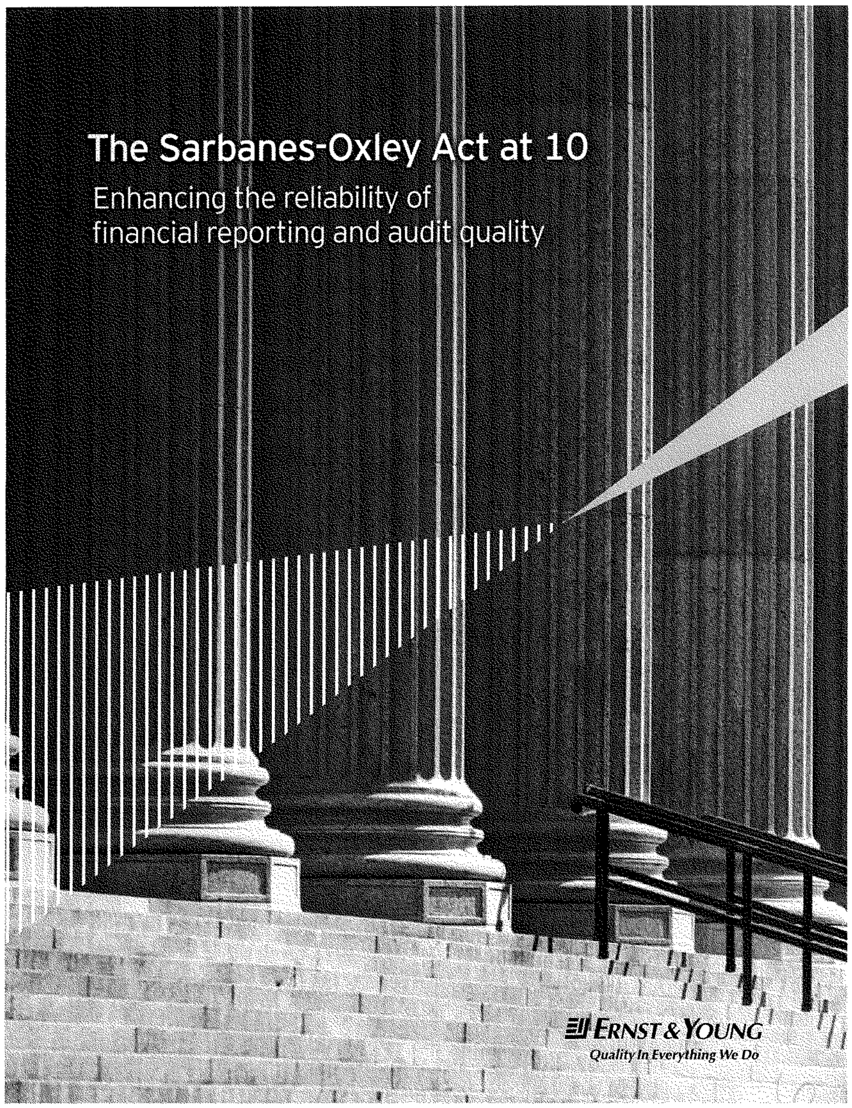
I thank our witnesses for appearing this morning and I yield back the balance of my time.

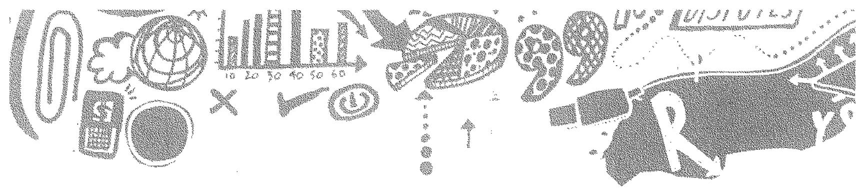
Statement
Representative Gwen Moore
House Financial Services Committee
Subcommittee on Capital Markets
Hearing entitled "The 10th Anniversary of the Sarbanes-Oxley Act"
July 26, 2012

I want to begin by thanking the Chairman and Ranking Member for holding this hearing and to the witnesses for their testimony today.

I hope to take advantage of this hearing to find opportunities to improve the Sarbanes-Oxley Act.

Thank you and I look forward to hearing from our witnesses.


The Sarbanes-Oxley Act at 10
Enhancing the reliability of
financial reporting and audit quality
Ernst & Young
Quality In Everything We Do



Ten years ago, the US capital markets were roiled by revelations of financial wrongdoing at numerous major companies. The damage to investors, pensioners, communities and markets was historic. Corporate executives were jailed. One of the nation's largest companies and one of the largest audit firms went out of business. After hundreds of corporate earnings restatements, confidence in financial markets was shaken to the core.

To restore public confidence in the reliability of financial reporting, the US Senate and House of Representatives passed the Sarbanes-Oxley Act of 2002, by votes of 99-0 and 423-3, respectively, sending it to President George W. Bush, who signed the reform measure into law on July 30, 2002. Since its enactment, the Sarbanes-Oxley Act, or SOX as it is often called, has been both heralded and maligned. Ernst & Young believes it is important to consider what the Act was actually designed to do and to revisit the significance of its impact.

SOX was designed to enhance the reliability of financial reporting and to improve audit quality. At Ernst & Young, we believe it has done both; although, more work surely remains. SOX forged a new era for the US audit profession by ending over 100 years of self-regulation and establishing independent oversight of public company audits by the Public Company Accounting Oversight Board (PCAOB). SOX strengthened corporate governance, shifting responsibility for the external auditor relationship away from corporate management to independent audit committees. It instituted whistleblower programs, CEO and CFO certification requirements and stricter criminal penalties for wrongdoing, including lying to the auditor. These measures and others were geared toward improving the reliability of corporate financial reporting.

Over the last 10 years, key elements of the Act have been replicated around the world, perhaps the purest form of flattery. Today, on the heels of the global financial crisis, many jurisdictions are looking anew at policy improvements similar to those instituted by SOX.

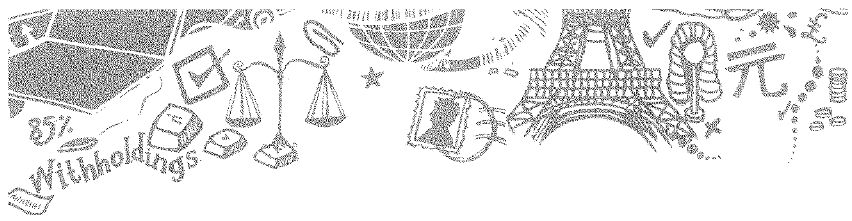
To be sure, Sarbanes-Oxley has received its share of criticism over the years, the bulk of which has focused on Section 404 relating to internal controls over financial reporting. Such concerns have been addressed since the passage of SOX through a series of regulatory and legislative actions, including changes enacted earlier this year.

At Ernst & Young, we believe history has shown, and will continue to show, that the Sarbanes-Oxley Act as a whole has afforded a substantial benefit to investors and US capital markets. We believe that one of the greatest successes of the Sarbanes-Oxley Act was to align the interests of auditors, independent audit committees and audit oversight authorities with those of shareholders. In our view, as the 10th anniversary of the Sarbanes-Oxley Act approaches, the Act continues to provide a solid foundation from which to further this alignment.

This document reviews the Act's key provisions, perspectives on some improvements engendered by SOX and opportunities for further enhancements to the financial reporting system.

James S. Turley
Global Chairman and CEO

Steve Howe
Americas Managing Partner and Managing Partner of the US Firm



Principal components of the Sarbanes-Oxley Act of 2002

I. Established independent oversight of public company audits
- Established the PCAOB, which ended more than 100 years of self-regulation by the public company audit profession
- Provided the PCAOB with inspection, enforcement and standard-setting authority

II. Strengthened audit committees and corporate governance
- Required audit committees, independent of management, for all listed companies
- Required the independent audit committee, rather than management, to be directly responsible for the appointment, compensation and oversight of the external auditor
- Required disclosure of whether at least one "financial expert" is on the audit committee

III. Enhanced transparency, executive accountability and investor protection
- Required audit firms to disclose certain information about their operations for the first time, including names of clients, fees and quality control procedures
- Required the CEO and CFO to certify financial reports
- Prohibited corporate officers and directors from fraudulently misleading auditors
- Instituted clawback provisions for CEO and CFO pay after financial restatements
- Established protection for whistleblowers employed by public companies who report accounting, auditing and internal control irregularities
- Required management to assess the effectiveness of internal controls over financial reporting (404(a)) and auditors to attest to management's representations (404(b))
- Established the "Fair Funds" program at the Securities and Exchange Commission (SEC) to augment the funds available to compensate victims of securities fraud

IV. Enhanced auditor independence
- Prohibited audit firms from providing certain non-audit services to audited companies
- Required audit committee pre-approval of all audit and non-audit services
- Required lead audit partner rotation every five years rather than seven

Established independent oversight of public company audits

Sarbanes-Oxley's establishment of the PCAOB, which ended more than 100 years of self-regulation at the federal level by the public company audit profession, is perhaps the most fundamental change made by SOX. Today, it is the PCAOB, not the profession, which regulates audit firms, establishes auditing and ethics standards, conducts audit quality inspections for the purpose of identifying issues related to audit quality, investigates allegations and disciplines auditors of public companies and broker-dealers.[1]

As of December 31, 2011, over 2,000 audit firms from more than 80 countries were registered with the PCAOB. In 2011, it conducted inspections of 213 registered audit firms, and initiated an interim inspection program for broker-dealers.[2] The PCAOB's standard-setting initiatives and inspections have contributed significantly to improvements in audit quality and auditor independence – affording investors significant benefits.

Standard setting

The PCAOB has the authority to set standards governing how auditors conduct audits of public companies and broker-dealers; auditor ethics and independence; and an audit firm's system of quality control. From time to time, the PCAOB identifies potential areas to be addressed via standard setting, including review and analysis of information obtained from inspections as well as input received from its Standing Advisory Group, which includes representatives from investor groups, the audit profession and public company board members.[3] The PCAOB also seeks comment from and publicly engages with a variety of stakeholders throughout the year via the public comment process, roundtables and other means. Recent and current standard-setting projects include those related to the auditor's risk assessment process, auditor communications with audit committees and the nature and content of the auditor's report.

In addition to standard setting, PCAOB staff issue practice alerts to draw auditors' attention to emerging issues or risks. Recent alerts have highlighted audit risks associated with the current economic environment and certain emerging markets. Ernst & Young believes the PCAOB's current standard-setting agenda has the potential to make significant additional contributions to audit quality.

1 Under Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB now has authority over the auditors of broker-dealers. This publication focuses on the PCAOB's regulation of public company auditors.

2 Data obtained from the PCAOB Annual Report 2011, available at www.pcaobus.org.

3 See *http://pcaobus.org/Standards/SAG/Pages/default.aspx*

> "While nobody likes to be inspected by their regulator, I truly believe that Ernst & Young and the entire profession will be better for it."
>
> **James S. Turley**
> Global Chairman & CEO, Ernst & Young
> Testimony before the US Senate Committee on Banking, September 9, 2004

Inspections

The PCAOB's inspection process is a significant element of its efforts to drive audit quality. Ernst & Young views the annual inspections as opportunities to further improve audit quality. The PCAOB inspects registered audit firms at intervals based on the number of public companies that the firm audits. Firms that perform annual audits of more than 100 issuers are inspected annually, while other firms are inspected at least every third year. The PCAOB uses a variety of factors to select the audits that it looks at for each audit firm it inspects, including its assessment of the risk that a public company's financial statements may contain a material misstatement.

These inspections provide an independent review of audit quality that highlight opportunities for improvement within audit firms, both at the individual audit level and with respect to a firm's system of quality control. Inspection results are used to identify areas in which additional audit guidance, training, practice reminders or enhanced skills may be needed, all of which enable audit professionals to improve their performance.

As part of each inspection, the PCAOB prepares a report, part of which is made publicly available. The public portion of the report cites audits where the PCAOB believes the firm failed to obtain sufficient evidence to support its opinion. The non-public portion of the inspection report includes concerns raised during inspections related to a firm's system of quality control. If an audit firm does not address those concerns to the PCAOB's satisfaction within a one-year period, the PCAOB's concerns are publicly reported.[4]

Enforcement

The PCAOB's enforcement staff actively investigates and sanctions individual auditors and audit firms for violations of laws, regulations and professional standards. The PCAOB's disciplinary powers include the authority to impose fines on individual auditors or the audit firm, revoke an audit firm's registration with the PCAOB (which would prevent it from performing audits of public companies and/or broker-dealers) and bar an individual auditor from association with registered audit firms. It also can punish firms and auditors that do not cooperate with PCAOB investigations and inspections and may refer matters to the SEC and other relevant authorities. The PCAOB publishes its settled and adjudicated disciplinary orders on its website to alert the public about the actions it has taken and against whom they have been taken.

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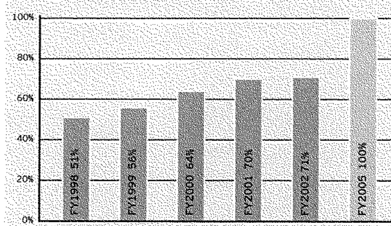
4 The Sarbanes-Oxley Act of 2002, §104(g)(2).

Strengthened audit committees and corporate governance

In a move that significantly strengthened corporate governance, Sarbanes-Oxley greatly expanded the responsibilities of audit committees.[5] SOX required the boards of companies listed on US stock exchanges to establish audit committees made up solely of board members independent from management. Because of SOX, audit committees, not management, are directly responsible for the appointment, compensation and oversight of the work of external auditors, who are charged with evaluating whether the financial statements prepared by management are fairly presented in accordance with the relevant financial reporting framework.

With respect to the composition of the audit committee, SOX enhanced and codified changes the SEC and US stock exchanges had begun making in the late 1990s. In 1998, only about half of all public companies had fully independent audit committees (see table). Many audit committees were reconstituted in order to meet the new independence requirements outlined by the SEC and US stock exchanges in late 1999.[6] SOX went further and enhanced independence requirements to require for the first time that all listed company audit committee members be independent, meaning they could not be affiliated with the company or any subsidiaries, and did not directly or indirectly receive any compensation from the company other than in their capacity as members of the board.

Evolving audit committee independence – S&P 1500 companies[7]



While the exchanges and the SEC began to make improvements at the end of the 1990s, SOX transformed the composition of audit committees. The new SOX audit committee independence rules became effective at companies' first annual shareholders meetings after January 15, 2004.

SOX also encouraged audit committees to have at least one member who is a "financial expert"[8] to serve as a resource to help the audit committee carry out its duties. This puts the audit committee in a stronger position to review and challenge financial statements, determine whether internal controls are appropriate and sufficient and, if necessary, perform certain accounting actions to protect shareholder interests. Companies that do not have an audit committee member with financial expertise must disclose this in the annual proxy statement and explain the rationale for not having one. In 2003, only a small number of audit committee members were financial experts. Today, almost one-half of all audit committee members are identified through proxy statement disclosure as meeting the definition of a financial expert.[9]

5 Audit committees are made up of members of the board of directors and oversee the companies' accounting and financial reporting process. Securities Exchange Act §3(a)(58).

6 In 1999, the New York Stock Exchange, American Exchange, and NASDAQ approved rules to require that their listed companies have audit committees composed of directors independent of management, unless the board made a special determination that it was in the best interests of the company to have one audit committee member that was not independent. Each exchange had its own definition of "independent." In addition, the SEC issued a rule to require disclosure of whether the audit committee members of public companies were independent, as well as certain information about any non-independent members.

7 Source: 2005 through present, Ernst & Young's corporate governance database; prior year data Investor Responsibility Research Center, Board Practices/Board Pay.

8 Generally, a financial expert is a person who, through education and experience, has an understanding of and experience in applying generally accepted accounting principles and preparing financial statements, experience with internal controls and procedures for financial reporting, and an understanding of audit committee functions. SOX §407, 17cfr229.407(d)(5)(ii).

9 Source: Ernst & Young's corporate governance database, which is based on SEC filings.

> "Prior to SOX, the process for the selection and assessment of the independent auditor typically was controlled by management... Audit committees now play an essential role in our corporate governance framework by overseeing the quality and integrity of the company's financial statements."
>
> National Association of Corporate Directors, *Directors*
> December 14, 2011

To facilitate its oversight of a company's financial reporting, SOX required companies to provide audit committees with the resources and authority to engage independent counsel and advisers to help them carry out their duties. SOX also required audit committees to establish procedures for receiving whistleblower complaints regarding accounting, auditing and internal control irregularities and to provide for the confidential and anonymous treatment of employee concerns regarding such matters. In addition, SOX enhanced the external auditor's required communications with the audit committee to include the following:

- A discussion of all critical accounting policies and practices used by the company
- All alternative accounting treatments that have been discussed with management, the ramifications of the use of alternative disclosures and accounting treatments and the accounting treatment preferred by the audit firm
- Other material written communications between the auditor and management

These reforms significantly empowered audit committees and they began to take a more active role to carry out their increased responsibilities. For example, audit committees for the S&P 500 companies met on average five times a year in 2001.[10] The average number of annual meetings has nearly doubled to nine today.[11] Audit committees also are exercising ownership of the relationship with the auditor. In a 2008 audit committee survey reported by the Center for Audit Quality, 90% of audit committee members surveyed said that "they work more closely with the independent auditor" post-SOX.[12] As part of this increased focus, interaction and oversight, audit committees are asking the external auditor more probing questions and meeting with the audit firm's subject matter experts and senior leadership throughout the year, not just during formal meetings. Collectively, these reforms have contributed to significant enhancements in audit quality.

To learn more about audit committee best practices, please visit www.ey.com/auditcommittee.

Ernst & Young and the Tapestry Networks: enhancing audit committee leadership and influence

Through the active support and engagement of Ernst & Young, Tapestry Networks organizes and leads nine audit committee networks across North America that collectively consist of 150 individuals, who chair more than 200 audit committees and sit on over 380 boards at some of the world's leading companies.

These audit committee chairs work together and with key stakeholders to improve committee performance and raise the bar on governance practices. Network members share emerging best practices and insights into issues that dominate the audit committee environment. The networks also provide an opportunity for dialogue with stakeholders such as regulators, standard-setters and the investor community.

After each meeting, Tapestry publishes its *ViewPoints* and *VantagePoints*, which are made publicly available to stimulate board discussions about the choices confronting audit committee members, management and their advisers as they fulfill their respective responsibilities to the investing public.

10 Source: 2005 through present, Ernst & Young's corporate governance database; prior year data, Investor Responsibility Research Center, Board Practices/Board Pay, 2001 and 2002: The Structure and Compensation of Boards of Directors at S&P Super 1500 Companies.

11 Spencer Stuart 2011 Board Index, *http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI2011.small022212.pdf*

12 Source: Center for Audit Quality, "Report on the Survey of Audit Committee Members," March 2008, *http://www.thecaq.org/newsroom/pdfs/auditsurvey.pdf*

Enhanced transparency, executive accountability and investor protection

One of the core elements of Sarbanes-Oxley was to clearly define and place responsibility for a company's financial statements with its chief executive officer and chief financial officer. SOX mandated that these executives certify the following items (among others) for each annual and quarterly report:

- They have reviewed the report
- Based on their knowledge, the financial information included in the report is fairly presented
- Based on their knowledge, the report does not contain any untrue statement of material fact or omit a material fact that would make the financial statements misleading
- They acknowledge their responsibility for establishing and maintaining internal controls over financial reporting and other disclosures
- They have evaluated the effectiveness of these controls, presented their conclusion as to effectiveness and disclosed any material changes in the company's controls

By making management executives fully accountable for their companies' financial statements, Sarbanes-Oxley set a clear tone for corporate responsibility and helped restore investors' confidence in financial statements. To enhance the significance of these certifications, SOX mandated stiff penalties for executive officers who certify that financial reports comply with the various regulatory requirements while knowing that they do not. Such penalties include potential SEC enforcement action, forfeiture of bonuses and profits, or criminal penalties such as fines or imprisonment.[13] As a further step to help restore investor confidence in corporate financial statements, SOX required companies to have an auditor attest to the effectiveness of the company's internal controls over financial reporting.

To supplement the financial relief available to victims of securities fraud, SOX also established the "Fair Funds" program at the SEC. This program allows the SEC to add monetary penalties paid by those who commit securities fraud to the funds available for distribution to wronged investors.[14]

In addition to requiring the chief executive and chief financial officers to certify that the financial statements are fairly presented in accordance with the relevant financial reporting framework, Sarbanes-Oxley established a number of important additional investor protections:

- Public companies are now required to provide enhanced disclosures in annual and quarterly reports regarding material off-balance sheet transactions, arrangements and obligations
- Public companies are required to report material changes in the financial condition or operations of the company on a rapid and current basis
- Board members of public companies, officers and investors who own more than 10% of the shares of a public company must file reports specifying the number of shares bought or sold within two days of the transaction
- Board members and executive officers of public companies are prohibited from trading shares during a specific blackout period before and after earnings reports or when other material results are disclosed

13 SOX §304 requires CEOs and CFOs to reimburse issuers for bonuses and profits on the sale of the issuer's shares over the preceding 12 months if the issuer restates its financial statements due to misconduct. Section 954 of the Dodd-Frank Act of 2010 requires companies to establish policies to recover incentive-based pay of any current or former executives awarded over the three years prior to a restatement, regardless of whether there was misconduct. The SEC has not yet issued a rule to carry out this requirement.

14 Prior to SOX, these funds were paid to the US Treasury.

A November 2009 study published by Audit Analytics found the rate of financial restatements was 46% higher for companies that did not comply with all of the Sarbanes-Oxley internal control provisions.

Internal controls over financial reporting

Sarbanes-Oxley requires public companies to assess how effective their internal controls over financial reporting are at preventing misstatements that could be material to the financial statements. While public companies have long been required to maintain effective systems of internal controls, pursuant to the Foreign Corrupt Practices Act of 1977, SOX requires them to annually evaluate their financial internal controls and to disclose the results of that assessment. This includes whether there were any weaknesses that may not prevent or detect a material misstatement in the financial statements.

SOX Section 404(a) requires management to report on the effectiveness of the company's internal controls over financial reporting, and Section 404(b) requires the auditor's attestation regarding their effectiveness. SEC rulemaking and legislation subsequent to SOX (e.g., the Dodd-Frank Act and the JOBS Act) have delayed or eliminated the requirement for certain companies to comply with Section 404(b). These include non-accelerated filers and emerging growth companies.

Internal controls over financial reporting are processes that provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. These include policies and procedures that:

1. Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the registrant; and
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

The requirements to conduct the assessment and provide the related disclosures have widely been credited with improving public companies' systems of internal control and have also given investors additional insights and confidence with respect to a company's financial reporting.

Enhanced auditor independence

Sarbanes-Oxley strengthened auditor independence and established certain types of non-audit services as off-limits to audit firms that provide auditing services to a public company. In addition, the company's independent audit committee must pre-approve any of the permissible non-audit services performed by the external auditor.

To further enhance independence, SOX calls for the mandatory rotation of the lead engagement partner every five years, rather than seven years as had been required under prior professional standards. SOX also extended the five-year rotation requirement to the concurring audit partner.[15] During the rulemaking process following passage of Sarbanes-Oxley, the SEC further enhanced auditor independence by extending rotation requirements to other audit partners who have significant responsibilities on audits. These other audit partners are required to rotate off an engagement every seven years.

SOX prohibited audit firms from providing certain services to public companies they audit:

- Bookkeeping
- Financial information systems design and implementation
- Appraisal or valuation services or fairness opinions
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker, dealer, investment adviser, or investment banking services
- Legal and expert services unrelated to the audit

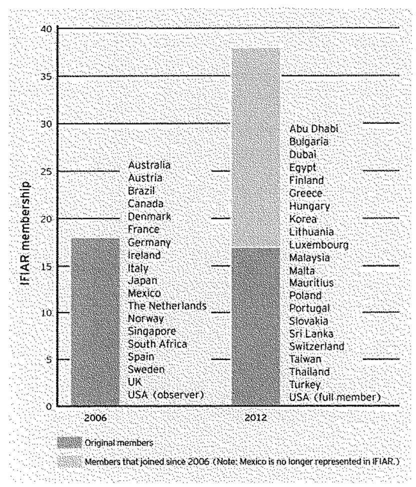
15 "Concurring audit partner"(or "engagement quality reviewer" as defined in PCAOB standards) is a partner, independent of the audit team, whose role is to perform an objective review of the significant judgments made by the audit team and the related conclusions reached in forming an opinion on the financial statements. Engagement quality reviewers must provide their approval prior to issuance of an audit report.

Looking ahead: the next 10 years

As companies continue to operate in more volatile, dynamic and global market conditions, audits will become increasingly complex – and even more critical to investor confidence. For this reason, Ernst & Young strongly supports a broad spectrum of efforts to improve audit quality and strengthen corporate governance.

For example, Ernst & Young supports enhancements to existing professional standards to strengthen the relevance, reliability and transparency of the audit process to investors. Some of the more significant recent efforts include the recently adopted standards related to the auditor's identification, assessment and response to the risks of material misstatement and engagement quality review. In addition, the PCAOB has a number of current initiatives that are intended to have a positive impact on audit quality, such as enhancements to the standards related to auditor communications with the audit committee, the auditor's reporting model, the auditor's consideration of related parties and the evaluation of fair value measurements.

At the global level, Ernst & Young expects to see increasing cooperation among audit regulators, many of which have been created since the passage of SOX. The International Forum of Independent Audit Regulators (IFIAR) was established in 2006 and has a steadily growing membership roster (see graph below).[16] The PCAOB is a member of IFIAR, which provides a forum for discussion of common concerns about and practices in audit firms. Ernst & Young supports measures to improve regulatory coordination across borders.



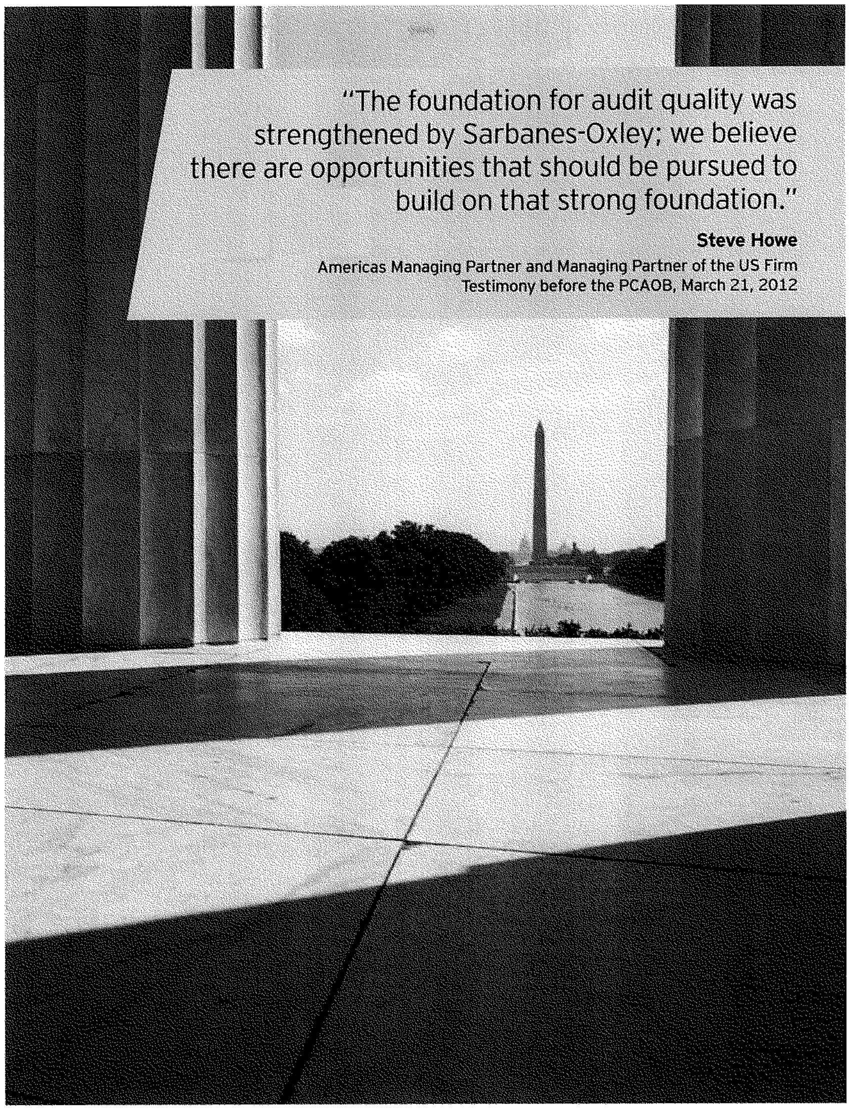
16 See https://www.ifiar.org/aboutus/index.cfm

Withstanding the test of time

While SOX put in place numerous improvements with respect to auditor oversight and independence, Ernst & Young believes that achieving and maintaining audit quality requires a process of continuous improvement. Auditors must always seek to improve in their work, given the dynamism and complexity of companies, global markets, financial products and the business environment. Fostering alignment through increased communication and transparency among auditors, audit committees and shareholders, as well as between audit committees and the PCAOB, is critical to improving audit quality and maintaining investor confidence in the financial reporting system. For that reason, Ernst & Young has outlined support for a number of policy initiatives with regulators around the world, including the PCAOB, related to these topics, and has contributed suggestions to further their study.[17]

Moving forward, Ernst & Young reaffirms its commitment to build upon the foundation established by SOX by working with the PCAOB, independent audit committees and shareholders. As the 10th anniversary of the Sarbanes-Oxley Act of 2002 approaches, we encourage a closer look at its provisions and impact, which we believe will stand the test of time.

17 For more information on the policy initiatives that Ernst & Young supports, please see *http://pcaobus.org/Rules/Rulemaking/Docket037/063_EY.pdf* and *http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Howe.pdf*


"The foundation for audit quality was strengthened by Sarbanes-Oxley; we believe there are opportunities that should be pursued to build on that strong foundation."
Steve Howe
Americas Managing Partner and Managing Partner of the US Firm
Testimony before the PCAOB, March 21, 2012

Key features of The Sarbanes-Oxley Act of 2002

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002 by a vote of 423-3 in the House, and 99-0 in the Senate. On July 30, 2002, President George W. Bush signed the measure into law (PL 107-204).

The following is an outline of the major requirements of the Act, broken into five sections: (1) consequences for issuers; (2) audit committee requirements; (3) board and corporate officer requirements; (4) audit firm requirements; and (5) the major amendments to SOX since its enactment.

I. Issuers

The Act has the following consequences for issuers:

1. Issuers are subject to the Act: The Act defines "issuer" as any company whose securities are registered, whether the issuer is domiciled in the United States or elsewhere, and any company required to file reports under §15(d) of the Securities Exchange Act of 1934 (§2).
2. Issuers must establish audit committees: The Act effectively requires all listed companies, whether US or non-US, to have fully independent audit committees (Title II generally).
3. The PCAOB can compel testimony and audit work papers related to an issuer: The PCAOB may require testimony or the production of documents or information in the possession of any registered audit firm or "associated person" of the firm relevant to an investigation. The PCAOB may also "request" documents and testimony from other persons, including issuers. If necessary, the PCAOB may request that the SEC issue a subpoena to assist it in its investigation (§105).
4. Issuers will be held responsible for associating with suspended or barred auditors: The Act prohibits an issuer from employing a person who has been suspended or barred from associating with any audit firm (§105).
5. Issuers are required to fund the PCAOB's and FASB's operations: The Act authorizes the PCAOB to fund itself by requiring issuers to pay an "annual accounting support fee." Issuers also are responsible for funding FASB (§108 and §109).
6. An issuer may not engage its auditor for nine specifically listed categories of non-audit services: The Act statutorily prohibits specifically listed categories of non-audit services from being offered by audit firms to their public audit clients (§201).
7. An issuer's audit committee must pre-approve all audit and non-audit services: Before an auditor can provide audit services or any non-audit service to a public audit client, the audit committee of the client must approve (§202).
8. Issuers must disclose approvals of non-audit services: Audit committee approvals of non-audit services must be disclosed in SEC periodic reports (§202).
9. Issuers must wait one year before hiring an audit engagement team member to be CEO, CFO, CAO or equivalent: The Act provides that an audit firm may not provide audit services for a public company if that company's chief executive officer, controller, chief financial officer, chief accounting officer, or other individual serving in an equivalent position, was employed by the audit firm and worked on the company's audit during the one year before the start of the audit services (§206).
10. Issuers must provide audit committees with adequate funding: Issuers must provide appropriate funding, as determined by the audit committee, for payment of compensation to the auditor and any advisers employed by the audit committee (§301).
11. Issuers must disclose off-balance sheet transactions: The SEC issued rules requiring that annual and quarterly financial reports disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer that may have a material current or future effect on the financial condition of the issuer (§401).
12. Issuers must reconcile pro forma information with GAAP and not omit information that otherwise makes financial disclosures misleading: The SEC issued rules providing that pro forma financial information disclosures must reconcile with GAAP and not be misleading (§401).

13. Issuers may not extend loans to board members or corporate officers: The Act makes it unlawful for an issuer to extend a loan to a board member or executive officer that is not made in the ordinary course of business of the issuer, and is not of a type generally made available to the public and on market terms (§402).

14. Issuers must disclose transactions involving management and principal stockholders: Section 16 of the Securities Exchange Act of 1934 was amended to require that changes in equity ownership by board members, officers and 10% stockholders must be reported within two business days after the day of the transaction. These "Section 16 filings" must be filed electronically and posted on the company's website (§403).

15. Issuers must make annual internal control reports: Issuers must make reports that (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) contain an assessment as of the end of the most recent fiscal year of the effectiveness of the internal control structure procedures of the issuer for financial reporting. The auditor must attest to, and report on, management's assertion (§404).

16. Issuers must disclose whether they have adopted codes of ethics for their senior officers: The SEC issued rules requiring companies to disclose whether they have adopted codes of ethics for senior officers. If not, issuers must explain their rationale for failing to do so (§406).

17. Issuers must disclose the existence of a "financial expert" on the audit committee: The SEC issued rules requiring issuers to disclose whether or not (and if not, reasons therefore) the audit committee has at least one member who is a "financial expert" (§407).

18. Issuers must disclose information about "material changes" on a real time basis: Public companies must disclose in plain English and "on a rapid and current basis" additional information regarding material changes in their financial conditions or operations (§409).

19. The Act creates criminal penalties for obstruction of justice by destruction of documents: The Act creates criminal penalties for obstruction of federal agency or other official proceedings by destruction of records. The Act provides for up to 20 years in jail for knowingly destroying or creating evidence with intent to obstruct a federal investigation or matter in bankruptcy (§802 and §1102).

20. The Act changes bankruptcy law regarding obligations incurred in violation of securities laws: The Act amends the federal bankruptcy code so that obligations arising from securities law violations cannot be discharged in bankruptcy (§803).

21. The Act creates longer statutes of limitations for securities fraud cases: The Act lengthens the statute of limitations for private federal securities fraud lawsuits from one year after the date of discovery of the facts constituting the violation and three years after the fraud to two years from discovery and five years after the fraud (§804).

22. The Act creates "whistleblower" protections for employees of issuers: The Act provides whistleblower protection to employees of publicly traded companies when they disclose information or assist in detecting and stopping fraud (§806 and §1107).

23. The Act creates criminal penalties for defrauding shareholders of publicly traded companies: The Act provides that anyone who "knowingly" defrauds shareholders of publicly traded companies may be subject to fines and imprisonment of up to 25 years (§807).

24. The Act enhances penalties for white collar crime: The Act increases jail time for conspiracy, mail and wire fraud, violations of ERISA, Exchange Act violations and retaliation against informants (§902, §903, §904, §1106 and §1107).

II. Audit Committees

The Act requires that audit committees:

25. Pre-approve all audit and non-audit services: The Act provides that both auditing and non-audit services must be pre-approved by the audit committee. The Act makes it "unlawful" for audit firms to perform nine specifically listed categories of non-audit services for their public audit clients. The Act specifically indicates that the performance of any other non-audit service by an audit firm for a public audit client is not prohibited, provided such services are "pre-approved" by the client's audit committee (§201, §202).

26. Have the ability to delegate pre-approval authority: The pre-approval of non-audit services may be delegated to a member of the audit committee. The decisions of any audit committee member to whom pre-approval authority is delegated must be presented to the full audit committee at its next scheduled meeting (§202).

27. Receive regular reports from the auditor on accounting treatments: An auditor must report to the audit committee on the critical accounting policies and practices to be used, all alternative treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments, and the treatment preferred by the auditor; any accounting disagreements between the auditor and management; and other material written communications between the auditor and management (such as any management letter and schedule of unadjusted differences) (§204).

28. Be responsible for oversight of the auditor: The Act provides that auditors shall report to and be overseen by the audit committee of a client, not management. The audit committee is "directly responsible for the appointment, compensation, and oversight" of the auditor's work (§301).

29. Be independent of the issuer: Audit committee members must be independent. In order to be considered "independent," an audit committee member may not accept any consulting, advisory or other compensatory fees from the issuer or be an "affiliated person" of the issuer or a subsidiary thereof (§301).

30. Establish complaint procedures: Audit committees must establish procedures for receiving and treating complaints regarding accounting and auditing matters, including complaints from those who wish to remain anonymous (§301).

31. Be given authority to engage advisers: Audit committees must "have the authority to engage independent counsel and other advisers, as it determines necessary, to carry out its duties" (§301).

32. Receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty: The SEC established rules for attorneys appearing before it that require them to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company to the chief legal counsel or the CEO. If management does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee (§307).

III. Boards of directors/Corporate officers

The Act imposes the following requirements on boards of directors and corporate officers:

33. The board of directors must either form an audit committee or take on such responsibilities: The Act requires boards of directors to either form an audit committee or otherwise take on the responsibilities of one (§2).

34. CEO and CFO must certify financial reports: An issuer's CEO and CFO must certify that periodic reports filed with the SEC are materially correct; that financial statements and disclosures "fairly present" the company's operations and financial condition in all material respects; and that they are responsible for evaluating and maintaining internal controls, have designed such controls to ensure that material information related to the issuer and its consolidated subsidiaries is made known to such officials and others within such entities, have evaluated the effectiveness as of a date within 90 days prior to the report, and have presented in their report their conclusions about the effectiveness of their internal controls. Further, they shall certify that they have disclosed to the auditor and audit committee all "significant deficiencies" in the design or operation of internal controls, including any material weaknesses, and any fraud, whether or not material, that involved management or other employees who have a significant role in the issuer's internal controls (§302).

    A separate criminal provision requires the signing officer to certify that each periodic report containing financial statements complies with securities laws and that the information in such report fairly presents, in all material respects, the financial condition and results of operations of the company. Failure to do so is a criminal felony, punishable by up to ten years in jail. A willful violation is punishable by a fine up to US$5 million and/or imprisonment of up to 20 years (§906).

35. Officers, directors and others are prohibited from fraudulently misleading their auditors: The Act prohibits "any officer or director of an issuer" and persons "acting under the direction thereof" from taking any action to fraudulently influence, coerce, manipulate or mislead any accountant engaged in preparing an audit report, for the purpose of rendering the audit report misleading (§303).

36. CEO/CFO must disgorge bonuses and profits after restatements due to misconduct: CEOs and CFOs must forfeit bonuses, incentive-based compensation and profits on stock sales if the issuer is required to issue a restatement due to misconduct (§304).

37. The SEC can bar "unfit" officers and directors: The Act gives the SEC authority to bring administrative proceedings to bar persons who are found to be "unfit" from serving as officers or directors of publicly traded companies. (Note: Under prior law, the SEC had to go to court to obtain such a bar, and the standard was "substantial unfitness.") (§305 and §1105).

38. Officers and directors are prohibited from trading during pension "blackout" periods: The Act prohibits corporate officers and directors from trading company securities during a pension fund "blackout" period (§306).

39. The CEO and chief legal counsel must receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty: The SEC established rules for attorneys appearing before it that require them to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company to the chief legal counsel or the CEO. If management does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee (§307).

40. The Act gives the SEC authority to temporarily freeze the pay of corporate officers: The Act gives the SEC authority to temporarily freeze the pay of corporate officers pending an investigation of securities fraud (§1103).

IV. Audit firms

The Act's regulatory board provisions require audit firms to:

41. Be subject to oversight by a new accounting oversight board: The Act established the PCAOB, which has broad powers over the profession. The PCAOB has five full-time members, appointed for staggered five-year terms. Two (and no more than two) of the members must be or have been CPAs. The SEC appoints PCAOB members (after consultation with other agencies) (§101).

42. Register with the PCAOB: Audit firms that perform audits of public companies must register with the PCAOB. The registration form requires firms to disclose: the names of audit clients; annual fees received from each issuer for "audit services, other accounting services, and non-audit services;" a statement of the firm's quality control policies; a list of all the firm's auditors, and licensing information; information relating to criminal, civil, or administrative actions or disciplinary proceedings pending against the firm or associated persons in connection with any audit report; copies of any SEC reports disclosing accounting disagreements between the firm and an issuer in connection with an audit report; any additional information the PCAOB specifies as necessary or appropriate in the public interest or for the protection of investors; consent to cooperate in and comply with any testimony or document production request made by the PCAOB; and an agreement to secure and enforce similar consents from "associated persons" of the firm (§102).

43. Submit periodic reports: Audit firms must submit annual updates of their registration to the PCAOB (more frequently if the PCAOB determines it necessary) (§102).

44. Pay fees to the PCAOB: Audit firms must pay registration fees and annual fees to the PCAOB to cover the costs of processing applications and annual reports (§102).

45. Comply with auditing and other professional standards: The Act requires the PCAOB to establish, or adopt by rule, "auditing and related attestation standards," as well as "ethics standards" to be used by audit firms in the preparation and issuance of audit reports. The Act indicates that the PCAOB may adopt standards proposed by "professional groups of accountants" (§103).

46. Comply with quality control standards: The Act requires the PCAOB to issue standards for audit firms' quality controls, including: monitoring of ethics and independence, internal and external consulting on audit issues, audit supervision, hiring, development and advancement of audit personnel, client acceptance and continuance, and internal inspections (§103).

47. Submit to quality control inspections: The PCAOB must regularly inspect audit firms' audit operations (annually for large firms) to assess the degree of compliance by those firms with the Act, the rules of the PCAOB, the firm's own quality control policies, and professional standards relating to audits of public companies (§104).

48. Subject foreign firms to PCAOB regulation: Foreign audit firms that "prepare or furnish" an audit report with respect to US registrants must register with the PCAOB and are treated the same as US audit firms for purposes of the Act (§106).

49. Secure the consent of foreign firms to PCAOB requests for documents if a domestic firm relies on its opinion: A domestic audit firm that relies upon the opinion of a foreign audit firm must "secure" the foreign firm's agreement to supply audit work papers to the PCAOB (§106).

The Act's legal and disciplinary provisions have the following consequences for audit firms:

50. Investigations and disciplinary actions: The PCAOB investigates potential violations of the Act, its rules, related provisions of the securities laws (and the rules) and professional accounting and conduct standards (§105).

51. Testimony and document production requests: The PCAOB may require testimony or the production of documents or information in the possession of any audit firm, "associated person," or any other person (including any client of an audit firm) if relevant to an investigation. All confidential information received by the PCAOB under the authority provided in §105 may be furnished to the SEC and appropriate federal functional regulators (§105).

52. PCAOB sanctions, including suspension: The PCAOB may impose sanctions for non-cooperation or violations, including revocation or suspension of an audit firm's registration, suspension from auditing public companies, and imposition of civil penalties (§105).

53. State and federal prosecution after referral from the PCAOB: The PCAOB may refer investigations to the SEC, or with the SEC's approval to the Department of Justice, state attorneys general, or state boards of accountancy, if such disclosure is "necessary to accomplish the purposes of the Act or to protect investors" (§105).

54. Sanctions for failure to supervise: The PCAOB may also impose sanctions upon an audit firm or its supervisory personnel for failure reasonably to supervise a partner or employee (§105).

55. Members of the audit engagement team must wait one year before accepting employment as an audit client's CEO, CFO, CAO or equivalent: The Act provides that an audit firm may not provide audit services for a public company if that company's chief executive officer, controller, chief financial officer, chief accounting officer, or other individual serving in an equivalent position, was employed by the audit firm and worked on the company's audit during the one year before the start of the audit services (§206).

56. Criminal penalties for destruction of corporate audit records: The Act creates a felony for the willful failure to maintain "all audit or review work papers" for five years. Pursuant to SOX, the SEC promulgated a rule on the retention of other audit records (paper and electronic) in addition to actual work papers (§802).

57. Longer statutes of limitations for securities fraud cases: The Act lengthens the statute of limitations for securities fraud from one year after the date of discovery of the facts constituting the violation and three years after the fraud to two years from discovery and five years after the fraud (§804).

The Act's internal procedure provisions require audit firms to:

58. Retain documents: Pursuant to SOX, the PCAOB issued standards compelling audit firms to maintain for seven years "audit work papers, and other information related to an audit report, in sufficient detail to support the conclusions reached in such a report" (§103).

59. Submit audits to second partner reviews: The PCAOB issued standards requiring audit firms to have second partner review and approval of each public company audit report (§103).

60. Rotate audit partners every five years: An audit firm must rotate its lead partner and its review partner on audits so that neither role is performed by the same accountant for more than five consecutive years (§203).

With respect to their public clients, the Act requires audit firms to:

61. Comply with PCAOB issued internal controls testing standards: The PCAOB issued standards requiring an auditor's report on its "findings" with respect to the audit client's internal control structure and the auditor's "evaluation" of whether the internal control structure and procedures "include a maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [GAAP], and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuers" (§103).

62. Attest to management's representations on internal controls: The Act requires management to assess and make representations regarding the quality of internal controls and requires audit firms to attest to and report on management's assessment (§404).

63. Cease offering certain non-audit services to public audit clients: The Act statutorily prohibits a number of non-audit services from being offered to public audit clients (§201).

64. Obtain audit committee preapproval for services: Before an audit firm can provide audit or non-audit services to a public audit client, the audit committee of the client must approve (§202).

65. Regularly report to audit committees on accounting treatments: Audit firms must report to the audit committee on the critical accounting policies and practices to be used, all alternative treatments of financial information within GAAP that have been discussed with management officials, the ramifications of the use of such alternative treatments, and the treatment preferred by the auditor; any accounting disagreements between the audit firm and management and other material written communications between the audit firm and management (§204).

66. Be responsible to the audit committee, not management: The Act provides that audit firms shall report to and be overseen by the audit committee of a company being audited, not management (§301).

V. Amendments to the Sarbanes-Oxley Act

Housing and Economic Recovery Act of 2008:

67. All confidential information received by the PCAOB under the authority provided in §105 may be furnished to the Director of the Federal Housing Finance Agency, at the discretion of the SEC (§1161).

Dodd-Frank Act of 2010:

68. Exempted all public companies classified as "non-accelerated filers" by the SEC from complying with §404(b) of the Sarbanes-Oxley Act (§989G).

69. Expanded the requirement of domestic audit firms to secure a foreign firm's audit work papers. Also required appointment of an agent for service of process in the US (§929J).

70. Authorized monetary awards to whistleblowers providing the SEC with information that leads to a successful enforcement action. Confidential information supplied to the SEC by a whistleblower may be furnished to the appropriate regulatory authority, the Attorney General of the United States, the PCAOB and others, at the discretion of the SEC (§922).

71. Expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined by the Securities Exchange Act of 1934 (§982).

72. Civil money penalties for securities laws violations may be used to benefit victims without obtaining disgorgement from the defendant, as was previously required under the Sarbanes-Oxley Act (§929B).

73. Expanded the definition of "person associated with an [audit] firm" to include persons "formerly associated with an [audit] firm" for purposes of investigative and enforcement authority (§929F).

74. Authorized the PCAOB to provide foreign auditor oversight authorities with all confidential information received by an audit firm under the PCAOB's §104 inspection or §105 investigation authority, at the discretion of the PCAOB and pursuant to certain qualifications (§981).

JOBS Act of 2012:

75. Exempted all companies defined within the Act as Emerging Growth Companies from complying with §404(b) of the Sarbanes-Oxley Act (§103).

76. Exempted all companies defined in the Act as Emerging Growth Companies from complying with any new accounting standard until such date that private companies must comply, if such standard applies to private companies at all (§102).

77. Exempted all companies defined within the Act as Emerging Growth Companies from complying with any PCAOB rules requiring mandatory firm rotation or auditor discussion and analysis (§104).

78. Exempted all companies defined within the Act as Emerging Growth Companies from complying with other new auditing standards unless the SEC determines that the application of such standard is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation" (§104).

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ED None.

Competitive Enterprise Institute

STATEMENT BY

JOHN BERLAU

SENIOR FELLOW, FINANCE AND ACCESS TO CAPITAL

COMPETITIVE ENTERPRISE INSTITUTE

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

"The 10th Anniversary of the Sarbanes-Oxley Act"

Washington, DC

July 26, 2012

Chairman Garrett, Ranking Member Waters, and honorable members of this subcommittee, thank you for this opportunity to present testimony on behalf of my organization, the Competitive Enterprise Institute.

My organization, the Competitive Enterprise Institute, is a Washington-based free-market think tank that since its founding in 1984 has studied the effects of all types of regulations on job growth and economic well-being. As we have said before, we follow the regulatory state from "economy to ecology," and propose ideas to "regulate the regulators" and hold them accountable so that innovation and job growth can flourish in all sectors.

Our theme on job growth has been "liberate to stimulate," because as our Vice President Wayne Crews has observed, one doesn't need to teach – or subsidize -- grass to grow. Rather, remove the rocks obstructing its growth, and it will grow wide and tall. And this law called SOX is definitely one of the biggest "rocks."

This hearing marks the occasion of the tenth anniversary of the passage and signing of SOX, the Sarbanes-Oxley Act of 2002, and I must confess that on past anniversaries of this law, I had not found much to celebrate.

I had looked at the cost burden of just one section of this law, the "internal control" mandates of Section 404, originally estimated by the Securities and Exchange Commission to cost a public company an average of $92,000 per year. The SEC has recently said that this burden is more like an average of $2.3 million per year. And the worst part is that the SEC has found that the cost burden for smaller companies is still more than seven times greater that than that imposed on large firms relative to their assets.

I had listened to Home Depot co-founder Bernie Marcus say several times that he and his partner could not have taken Home Depot public had SOX been in effect in 1981. Mr. Marcus has stated this belief to many interviewers, including radio Host Hugh Hewitt and FOX News' Greta VanSusteren. And I heard him state his belief that if the company had not raised this initial capital by going public back then, he and his partner could not have built it into the powerhouse chain it is today, serving so many satisfied customers and employing more than 300,000 workers.

I had compared Home Depot's size when it went public in 1981 – just four stores in the chain – to that of Facebook's ill-fated initial public offering -- $100 billion in market capitalization – as well as that of recent IPOs of Groupon and LinkedIn that had market caps exceeding $1 billion. This is part of a post-SOX trend of both fewer U.S. IPOs – in no year since SOX passed has the number of IPOs approached that of the early '90s recession years, let alone the late '90s boom years – and much larger IPOs. According to President Obama's Council on Jobs and Competitiveness, "the share of IPOs that were smaller [in market capitalization] than $50 million fell from 80 percent in the 1990s to 20 percent in the 2000s."

The reduced number of IPOs was making it that much harder to climb out of the economic hole. As the President's Job Council noted, "the data clearly shows that job growth accelerates when companies go public." As the council and others have noted, 90 percent of a public company's job creation occurs after it goes public. Directly fingering SOX, the council observed: "Well-intentioned regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on the large number of smaller companies. As a result, fewer high-growth entrepreneurial companies are going public."

Companies waiting until they were almost as big as Facebook before they went public also meant that ordinary investors would lose out on opportunities, as they had with Home Depot and countless firms in the '80s of 90s, of buying into emerging companies at their growth stages and growing wealthy along with the firms.

And as an advocate for investors as well as entrepreneurs, I observed with deep sadness the implosions of many companies fully subject to SOX rules – such as Lehman Brothers and MF Global. The trivial minutiae that SOX had companies and their accountants document – at such high cost to legitimate companies – seemed to do little to prevent massive mismanagement or outright fraud at troubled firms. As Hal Scott, Nomura Professor of International Financial Systems at Harvard Law School, has written, despite SOX 404's "high costs, it remains empirically unclear whether adherence to SOX 404 achieves its intended benefit: reduced incidence of fraud or opaque or aggressive accounting practices by public companies."

So up until a few months ago, I and many entrepreneurs and investors were not exactly in a mood for celebration in looking forward to SOX's big 10. But then this House, the Senate, and President Obama pleasantly surprised me with a powerful first step towards SOX reform and relief. In April, President Obama signed, after it overwhelmingly passed this House and this subcommittee, the Jumpstart Our Business Startups (JOBS) Act.

Among other things, the JOBS Act creates a five-year "on-ramp" for firms going public that have market caps of less than $1 billion and annual revenues of less than $700 million in which they are exempt from the Sarbanes-Oxley internal control mandates, costly provisions of Dodd-Frank that specifically apply to public companies, and other burdensome regulations. And this provision, which went into effect immediately after the legislation was enacted, is already paying dividends to entrepreneurs, investors and the economy as a whole.

We know that in the mere three months since passage of the law, at least 46 emerging-growth f firms have taken advantage of this JOBS Act provision in planned IPOs. I have attached the names of these companies in an appendix to this testimony. What's even more remarkable, and convincing evidence of SOX's true burden to smaller firms, is the size of these IPOs. For instance, ClearSign Combustion, a respected Seattle-based green technology firm, launched an IPO under the JOBS Act on-ramp in late April with a market cap of just $12 million. I don't believe we have had IPOs this small since before SOX went into effect.

The JOBS Act is a big improvement, but there is so much more that can be done to nurture job growth and innovation at small and large public companies and to lift barriers to more firms going public. The Fostering Innovation Act (H.R. 6161), would provide a needed supplement to the regulatory relief in the JOBS Act. By making sure that midsize companies aren't misclassified by the SEC as large due to a sudden spike in their share prices, the bill would help ensure that these job-creating firms have time to grow.

We also need to eventually get rid of Section 404 and other onerous SOX provisions for all public companies. If these rules aren't providing benefits to investors and the public that exceed their costs, there is no reason why any firm should be weighed down by these provisions when resources now devoted to compliance could be used to expand and create jobs. As Mallory Factor, serial entrepreneur and professor of international politics and American government at The Citadel, has put it, "This is capital that could be invested in infrastructure improvements, job creation, and innovative technologies or research and development."

But all in all, with the JOBS Act passage, there is reason to celebrate SOX's birthday this year, and I and thousands of investors and entrepreneurs who are little less burdened by this law are ready to break out the birthday cake and champagne. So thank you again for inviting me to testify and additional thanks to nearly all the members of this subcommittee who supported the JOBS Act. I am happy to answer any questions you may have.

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Appendix

List of emerging-growth companies already utilizing Sarbanes-Oxley relief from the Jumpstart Our Business Startup Act

July 2012:
Gigamon LLC
Delek Logistics Partners, LP
Hi-Crush Partners LP
Audeo Oncology, Inc.
Performant Financial Corp
GlobeImmune INC
MPLX LP

June 2012:
Natural Grocers by Vitamin Cottage, Inc. (NGVC)
Qualys, Inc.
iWatt Inc

May 2012:
Kythera Biopharmaceuticals Inc.
Shutterstock
OncoMed Pharmaceuticals
Legalzoom

April 2012:
Southcross Energy Partners, LP

"Emerging Growth Companies" that filed public registration statements prior to enactment of the JOBS Act but after December 8, 2011 and thus amended their registration statement to take advantage of the retroactivity of the law:

April 1-15, 2012:
FiveBelow
Stemline Therapeutics
Hyperion
Palo Alto

March, 2012:

Service NOW
Reval Holdings
ADMA Biologics
Globus Medical
Tesaro, Inc.
Durata Therapeutics
Ginkgo Residential Trust
Exponential Interactive
American Oil & Gas
Fender Musical Instruments Corp

Feb 2012:
E2Open
Diamondback Energy
EQT Midstream Partners, LP
Quicksilver Production Partners

Jan 2012:
Tria Beauty Inc
Del Frisco's Restaurant Group
China Auto Rental Holdings Inc
Audience Inc
Splunk Inc
Pacific Coast Oil Trust
Infoblox Inc
Extend Health Inc
UTE Energy Upstream Holdings LLC

Dec 2011:
Cancer Genetics, Inc.
GoGo Inc.
Avast Software
Coskata, Inc.
*Cantor Entertainment filed public S-1 in Dec and withdrew it after enactment of the JOBS Act in order to take advantage of confidential filing

Testimony of Mercer E. Bullard

President and Founder
Fund Democracy, Inc.

and

Jessie D. Puckett, Jr., Lecturer and
Associate Professor of Law
University of Mississippi School of Law

before the

Subcommittee on Capital Markets and
Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

on

The 10th Anniversary of the Sarbanes-Oxley Act

July 26, 2012

Chairman Garrett, Ranking Member Waters, members of the Subcommittee, thank you for the opportunity to appear before you today on the occasion of the 10th anniversary of the Sarbanes-Oxley Act. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a Jessie D. Puckett, Jr., Lecturer and Associate Professor of Law at the University of Mississippi School of Law. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the CFP Board's Public Policy Council; and an Accredited Investment Fiduciary. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee; an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

This testimony is based on my general experience over a number of years as an investor advocate, journalist, academic, regulator, financial planner, private practitioner and expert witness and consultant. I have been engaged in securities regulation issues from a variety of perspectives and attempt to provide testimony that reflects the interests of investors, diverse views of various constituents, and the practical exigencies of real-world legal practice and compliance.

I. Introduction and Summary

The primary focus of the Sarbanes-Oxley Act of 2002 ("SOXA") reflects the accumulation of corporate accounting scandals that was its primary impetus.[1] First, the Act includes a wide range of provisions that are designed to ensure the

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[1] *See, e.g.*, S. Rep. No. 107-205, at 23 (2002) ("Senate Report") ("Defects in procedures for monitoring financial results and controls have been blamed for recent corporate failures."); H. Rep. No. 107-414, at 18 – 19 (2002) ("House Report") ("The Committee's hearing on the Enron matter, the collapse of Global Crossing LLC, and the operations of the Nation's capital markets all indicated that reforms were necessary both for the regulators and the regulated.").

reliability of financial information provided by public companies. Second, the Act includes numerous provisions that are specifically designed to hold corporate executives, directors, and public auditors to the highest standards of integrity. Together, these provisions aim to enhance the reliability of financial reporting and hold CEOs, CFOs, directors, and public auditors who engage in financial fraud accountable for their actions.[2]

It would be a mistake, however, to explain the Act simply as a reaction to the scandals *de jour*. While corporate accounting scandals may have created the tipping point for action, many of the Act's provisions reflected long-debated policies.[3] The scandals gave the problems that the Act is designed to address a more concrete face and solidified broad-based support. Nor could the Act could not be said to reflect partisan lawmaking. Of 525 votes cast in the House and Senate, only three opposed the Act. The President's statement issued at the signing of the Act was unequivocally positive.[4]

Although parts of the Sarbanes-Oxley Act have been the subject of criticism -- Section 404 in particular -- it also has enjoyed broad support among investor advocates, public companies and auditing firms. Some parts of SOXA have been quite successful, but some parts could be improved. Due to the size of the Act and

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[2] *See* Remarks by President Bush at the signing of the Sarbanes-Oxley Act of 2002 (July 30, 2002) ("President's Remarks") ("This law says to shareholders that the financial information you received from a company will be true and reliable, for those who deliberately sign their names to deception will be punished."); Senate Report, *supra* at 2 (the Act "requires steps to enhance the direct responsibilities of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies"); House Report, *supra* at 16 (the Act "will protect investors by improving the accuracy and reliability corporate disclosures made pursuant to the securities laws. The bill achieves this goal through increased supervision of accountants that audit public companies, strengthened corporate responsibility, increased transparency of corporate financial statements, and protections for employee access to retirement accounts.").

[3] *See, e.g., The Numbers Game*, Remarks by Arthur Levitt, Chairman, SEC, before the NYU Center for Law and Business, New York, NY (Sep. 28, 1998) *available at* http://sec.gov/news/speech/speecharchive/1998/spch220.txt.

[4] *See President's Remarks, supra.*

time constraints, this testimony discusses only a few of SOXA's provisions in any detail, in addition to the Fostering Innovation Act. The primary points in this discussion are as follows:

- The bifurcation of public companies between those that are subject to SOXA Section 404's broad internal control provisions and those that are not compromises the quality and reliability of public company accounting, and undermines investor confidence[5] and the integrity of the markets. The costs of compliance results not from Section 404, but from its implementation by regulators who are in the best position to evaluate costs and make appropriate adjustments. In my view, the Fostering Innovation Act would exacerbate these problems. The details of Section 404 implementation should be left to the expert regulators based on their weighing of the costs and benefits for issuers and investors.

- SOXA's whistleblower provisions have been substantially undermined by a First Circuit holding that they do not protect employees of nonpublic companies, even if the whistleblowing relates to a public company's compliance. Congress should amend SOXA Section 806 to clarify that public companies cannot evade whistleblower protections simply by retaining nonpublic companies for accounting and other compliance-related services.

- Section 403 of SOXA has substantially mitigated executive compensation abuses by requiring that executives report transactions in company securities within two business days. This provision has been particularly effective in preventing fraudulent backdating of stock options. However, empirical research shows that such backdating continues to be a problem because a large percentage of executives are violating the two-day reporting requirement. Enhanced enforcement and penalties should be considered to ensure compliance with this requirement.

In addition, I have briefly addressed below a series of issues for which time constraints have not permitted fuller discussion.

- Public PCAOB Proceedings: Section 105 of SOXA permits PCAOB proceedings to be public only if the PCAOB finds good cause and both sides consent, which, as a practical matter, ensures that these proceedings will never be made public. Secret proceedings improperly deny the public, including issuers' audit committees, material information regarding auditors, and

[5] *See* Jeffry Love, *Sarbanes-Oxley: A Survey of Investor Opinions*, AARP and Knowledge Network (2007) ("*AARP Investor Survey*") (SOXA has made more than half of surveyed investors more confident in the information they received from companies).

increase auditors' incentives to litigate actions.[6] PCAOB enforcement proceedings should be public, just as SEC proceedings have been for 25 years. I urge Congress to amend SOXA to require that PCAOB proceedings be public except by order of the Board.[7]

- Auditor Rotation: A mandatory auditor rotation requirement was considered during the debates leading to SOXA but not enacted.[8] This proposal continues to have significant potential for improving auditor independence, especially in view of the decades-long tenure that some auditors have with their clients, notwithstanding that there would be undeniably material costs.[9] Although some have proposed to preempt the PCAOB by prohibiting an auditor rotation requirement,[10] in my view this issue is not ripe or appropriate for legislative action.[11] The PCAOB has been very sensitive to rotation concerns and is undertaking a careful re-evaluation of auditor term limits[12] that, when completed, should be afforded the deference due an expert regulator.

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[6] *See* Hearing before the Subcommittee on Capital markets and Government-Sponsored Enterprises, U.S. House of Representatives (Mar. 28, 2012) (testimony of James Doty, Chairman, PCAOB ("*Doty Testimony*") *available at* http://pcaobus.org/News/Speech/Pages/03282012_DotyTestimony.aspx; Statement of Claudius Modesti, Director of Enforcement, PCAOB, before the New York State Society of CPAs', New York, NY (Sep. 28, 2010) *available at* http://pcaobus.org/News/Speech/Pages/09282010_ModestiTransparency.aspx

[7] *See* H.R. 3503 (Nov. 18, 2011) (requiring public PCAOB proceedings except by determination of Board) *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112hr3503ih/pdf/BILLS-112hr3503ih.pdf.

[8] However, Congress generally required the rotation of audit partners in Section 203 of SOXA.

[9] *See* Letter from Barbara Roper, Director of Investor Protection, Consumer Federal of America, to Office of the Secretary, PCAOB (Dec. 14, 2011) *available at* http://pcaobus.org/Rules/Rulemaking/Docket037/484_CFA.pdf.

[10] *See* Memorandum from Committee Staff to Members, Committee on Financial Services, U.S. House of Representatives (Mar. 23, 2012) (citing discussion draft of bill to prohibit mandating auditor rotation) *available at* http://www.corpgovcenter.org/Carcello/capmrkts.pdf.

[11] *See Doty Testimony, supra.*

[12] The PCAOB requested public comment on auditor terms limits in August 2011, the comment period for which has not yet closed. *See* Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-006 (Aug. 16, 2011) *available at* http://pcaobus.org/Rules/Rulemaking/Docket037/Release_2011-006.pdf. In March and June of this year, the PCAOB held roundtables on terms limits. *See PCAOB Public Meeting on Firm Independence and Rotation*, Washington, D.C. (Mar. 11 – 12, 2012) *transcript available at* http://pcaobus.org/Rules/Rulemaking/Docket037/2012-03-21_Transcript-Notice.pdf and (June 28, 2012) *transcript available at* http://pcaobus.org/Rules/Rulemaking/Docket037/2012-6-28_Transcript-Notice.pdf.

- Auditor Certifications: SOXA Sections 302 and 906 require CEOs and CFOs to certify that the company's filings are not misleading and that any weaknesses in the company's internal controls have been disclosed to the company's auditors, and impose significant criminal penalties for knowing violations. Congress should consider requiring similar certifications for audit engagement partners[13] or that partners be required to sign audit reports (the latter has been proposed by the PCAOB).[14]

- Auditor Financials: Auditors are not themselves required to disclose audited financial statements. Congress should consider requiring the largest auditing firms provide and disclose audited financial reports in order to permit a fair evaluation of their financial condition, as has been recommended by a former member of Boeing's audit committee[15] and major institutional investors,[16] among others.

- Foreign Auditors: Section 106 of SOXA grants authority to PCAOB to register and inspect auditors, including foreign auditors, that play a substantial role in the preparation or furnishing of an audit report for a public company. [17] However, certain jurisdictions have prevented the PCAOB from conducting such inspections,[18] citing, among other things, conflicts with internal law.

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[13] *See* Submission of Paul Haaga, Jr., Vice Chairman, Capital Research and Management Company, to the Advisory Committee on the Auditing Profession (Feb. 4, 2007) ("*Haaga Submission*") *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/Haaga020408.pdf.

[14] *See Improving the Transparency of Audits*, PCAOB 2001-007 (Oct. 11, 2011) (proposing to require disclosure of name of engagement partner in audit reports) *available at* http://pcaobus.org/Rules/Rulemaking/Docket029/PCAOB_Release_2011-007.pdf; *Concept Release on Requiring the Engagement Partner to Sign the Audit Report*, PCAOB 2009-005 (July 28, 2009) *available at* http://pcaobus.org/Rules/Rulemaking/Docket029/2009-07-28_Release_No_2009-005.pdf.

[15] *See* John Biggs, Statement to the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury (June 3, 2008 (revised June 5, 2008)) ("With our greatly increased responsibilities and consequent risks as audit committee members, we rely heavily on the quality and strength of the audit firm we select to probe into all aspects of the company financial reporting. We need to know more about the firms we select and the risks of doing business with them.") *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/Biggs060308.pdf.

[16] *See, e.g., Haaga Submission, supra*, and other submissions cited at: Advisory Committee on the Auditing Profession, Department of the Treasury at n.93 (Oct. 6, 2008) *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf note 93.

[17] *See* PCAOB Rule 2100.

[18] *See Updated information on PCAOB International Inspections*, PCAOB (Dec. 11, 2011) *available at* http://pcaobus.org/International/Inspections/Documents/12312011_international_inspections_information.pdf; *Issuer Audit Clients of Non-U.S. Registered Firms in Jurisdictions where the PCAOB is*

> Issuers that use foreign auditors thereby enjoy a "documented cross-listing premium for bonding themselves to U.S." standards[19] without having to comply with those standards. The PCAOB has made significant progress in this area, and Congress should continue to support its efforts in this area.

Finally, much of the foregoing relates the responsibilities of the PCAOB, but without noting the importance of the PCAOB itself. The creation of the PCAOB is the centerpiece of SOXA and has been the Act's greatest contribution to the U.S. securities markets. The PCAOB has directly addressed the insidious lack of independence in the self-regulation of accounting under which no major accounting firm had ever been issued an adverse or qualified report.[20] In its brief history, the PCAOB has identified hundreds of accounting deficiencies in accounting firms in almost 2,000 inspections of firms' quality controls. It has appropriately exercised its authority to resolve issues with these firms and, when necessary, to conduct investigations and commence enforcement proceedings.[21] The PCAOB has made significant improvements in the standard-setting process while working assiduously to consider the interests of all affected parties, including especially small businesses. I strongly encourage Congress to continue to support the work of the PCAOB's and afford appropriate deference to its independent, expert judgment.

Denied Access to Conduct Inspections, PCAOB, *available at* http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx. *See generally* James Doty, *The Relevance, Role, and Reliability of Audits in the Global Economy*, 90 Texas L. Rev. 1891, 1907 - 10 (2012) *available at* http://www.texaslrev.com/sites/default/files/issues/vol90/pdf/Doty.pdf.

[19] Doty, *supra* at 1908.

[20] *See id.* at 1891.

[21] *See id.* at 1897 (record of 26 revocations of firms' registrations and 53 sanctions against individuals).

II. Section 404

The most heated criticism of SOXA has been reserved for its provisions on financial reporting internal controls.[22] Section 404(a) of SOXA requires that management assess and report on the effectiveness of internal control over financial reporting. Section 404(b) requires that a company's auditor attest to the effectiveness of the internal controls assessment under Section 404(a). Most of the criticism of these provisions has focused on the cost of compliance, particularly for smaller companies that have a smaller revenue base over which to spread fixed costs (*i.e.*, costs that do not decline with the size of the company being audited).

However, the actual text of Section 404 undercuts the logic of such criticism. The text requires nothing more than that management assume individual responsibility for financial reporting internal controls – a responsibility that a *bona fide* fiduciary duty under state corporate law presumably would already impose – and that the company's "registered public accounting firm" – which already would have responsibility for auditing the company's financial reports – attest to the effectiveness of internal controls. These general requirements are fundamental to effective accounting regulation. Section 404 leaves the details of implementation, that is, the elements that would actually determine the costs of compliance, to the Commission and the Board.[23]

Since the enactment of Section 404, regulators have demonstrated their sensitivity to cost issues. The Commission and the Board have considered and acted to reduce the costs of compliance borne by small companies, then measured the effect of their efforts, then again acted to reduce compliance costs, then again measured the effect of their efforts in what has been a fairly continuous re-

[22] *See* John Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, Columbia Law School Working Paper No. 414, at 25 (Jan. 9, 2012).

[23] *See, e.g.,* SOXA Section 404(b) (authorizing PCAOB to establish standards for attestation under Section 404(b)).

evaluation.[24] The PCAOB revised its initial auditor attestation standard after only two financial reporting cycles had been completed, specifically with the purpose of reducing costs for smaller companies. During this period, the costs of Section 404 compliance have steadily declined.[25]

[24] In the course of adopting a auditor attestation standard, the PCAOB conducted a roundtable to solicit input from interested parties, *see* PCAOB Roundtable on Reporting on Internal Control, Washington, DC (July 29, 2003) *webcast available at* http://pcaobus.org/News/Webcasts/Pages/07292003_Roundtable.aspx; developed and issued a proposed standard, *see Proposed Auditing Standard*, PCAOB Rel. No. 2003-017 (Oct. 7, 2003) *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/2003-10-17_Release_2003-017.pdf; revised the standard based on public input including 189 comment letters ("virtually all" expressed support for the PCAOB's approach, although some issuers raised cost concerns), *see* Auditing Standard No. 2, PCAOB Rel. No. 2004-03, Appendix E (Mar. 9, 2004) *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/Form_19b-4_Auditing_Standard_2.pdf; submitted its proposed standard to the Commission, *see Notice of Filing of Proposed Rule on Auditing Standard No. 2*, File No. PCAOB-2004-03 (Apr. 4, 2004) *available at* http://sec.gov/rules/pcaob/34-49544.htm, considered comments on that draft proposal, *see* comment letters at http://sec.gov/rules/pcaob/pcaob200403.shtml; filed a final rule for approval with the Commission, *see* Order Approving Proposed Auditing Standard No. 2, File No. PCAOB 2004-03 (June 17, 2004) (finding PCAOB carefully considered cost issues) *available at* http://sec.gov/rules/pcaob/34-49884.htm; held another roundtable on Section 404 compliance (with the Commission), *see* 2006 Roundtable Discussion on Implementation of Internal Control Reporting Provisions (May 10, 2006) *transcript and briefing document available, respectively, at* http://www.sec.gov/spotlight/soxcomp/soxcomp-transcript.txt & http://www.sec.gov/spotlight/soxcomp/soxcomp-briefing0506.htm; responded to complaints regarding cost of compliance by proposing a revised, more scalable standard, *see Proposed Auditing Standard*, PCAOB Rel. No. 2006-007 (Dec. 19, 2006) *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20021/2006-12-19_Release_No._2006-007.pdf, which was approved by the Commission in 2007. *See* Order Approving Proposing Auditing Standard No. 5, Sec. Act. Rel. No. 56152 (July 27, 2007) *available at* http://sec.gov/rules/pcaob/2007/34-56152.pdf. The PCAOB has established an Office of Outreach and Small Business Liaison and hosted numerous meeting with small business interests, including a forum series on audit reform. *See, e.g., Forum on Auditing in the Small Business Environment* (May 2, June 7 & 19, July 18, Sep. 13, and Nov. 7 & 29, 2012).

[25] *See Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between $75 and $250 Million*, Office of Chief Accountant, Securities and Exchange Commission at 7 (2011) (*2011 SEC Study and Recommendations*) (academic and other research on Section 404: Indicates that the cost of compliance with Section 404(b), including both total costs and audit fees, has declined since the 2007 reforms"; "costs of Section 404(b) have declined since the Commission first implemented the requirements of Section 404, particularly in response to the 2007 reforms") *available at* http://www.sec.gov/news/studies/2011/404bfloat-study.pdf; *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, Office of Economic Analysis, Securities and Exchange Commission at 2 (2009) ("*2009 SEC Study*") ("evidence also indicates that there is an economically and statistically significant reduction in Section 404 compliance costs following the 2007 reforms.") *available at* http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

In this respect, Section 404 has worked exactly as effective regulation should. Congress established a flexible, broad standard for ensuring the accuracy of financial reporting. Regulators have implemented that standard applying a generally balanced view of the costs of compliance and the benefits of reliable financial information and they continue to adjust their implementation of the Act to reflect new information and changing circumstances.

However, from Section 404's inception small firms representing a substantial percentage of public companies have been exempted from Section 404. Rather than allowing the rulemaking process to resolve inevitable missteps in the implementation of Section 404, business interests have demanded and been granted wholesale exemptions from Section 404 for entire categories of small companies. This was accomplished through a series of administrative exemptions,[26] followed by Dodd-Frank Act's Section 989G permanent exemption for all non-accelerated filers from Section 404(b), which represent approximately 60 percent of reporting issuers.[27] Section 103 of the Jumpstart Our Business Startups Act ("JOBS Act") exempted all "emerging growth companies," which includes any company, for up to almost six years after its IPO, with less than $1 billion in annual revenues.

While studies have found a steady decline in the costs of Section 404 compliance, the blanket-exemption approach followed by regulators and Congress has prevented any evaluation of the cost to small companies.[28] It is likely that costs would have declined for small companies as well, and information on such costs would have provided needed guidance for adjusting the implementation of Section 404 in the future. But blanket exemptions from Section 404 have prevented the maturation of its internal controls requirements into a consistent standard for

[26] *See* Securities Act Rel. Nos. 8392 (Feb. 24, 2004), 8545 (Mar. 2, 2005) & 8618 (Sep. 22, 2005). *See also Exposure Draft, supra* (recommending small company exemption from Section 404).

[27] *See 2011 SEC Study and Recommendations, supra* at 9.

[28] *See 2009 SEC Study, supra* at 1 - 2.

public companies in the U.S. Simply dividing companies between those to which the ***full attestation*** applies – larger companies that need it less – and those to which ***no attestation*** applies – smaller companies that need it more – is not an appropriate solution to the problem of compliance costs.[29] Rather, regulators should be allowed to evaluate compliance costs and adjust internal control requirements on an ongoing basis, including narrowing further the scope of the attestation.[30]

The foregoing reflects two broader problems that characterize much of current debates about securities regulation. First, the evisceration of Section 404 has undermined the coherence of the concept of a "public company" in the U.S. markets. The public company represents a distinctly U.S. brand, the integrity of which has played an instrumental role in the success of U.S. securities markets. When "public company" means something different for every company that wears that label, that brand loses its value as a coherent set of default rules on which investors can rely.

Second, the evisceration of Section 404 reflects the kind of regulatory tinkering that should be left to regulators. The legislative process is not an appropriate vehicle for the micromanagement of accounting standards and processes. Administrative agencies provide the combination of technical expertise, responsiveness, predictability and public accountability that is necessary for effective regulation.

[29] *See AARP Investor Survey, supra* (less than one-fifth of surveyed investors believe that small companies should be exempt or that there should be a compliance transition period for companies entering U.S. markets).

[30] *Accord* Separate Statement of Curt Schacht, *Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies,* Sec. Act Rel. No. 8666, 123 – 29 (Mar. 3, 2006) ("*Exposure Draft*")(recommending small company exemption from Section 404) *available at* http://www.sec.gov/rules/other/33-8666.pdf.

It should be noted that neither of these two concerns militates for or against the requirements of Section 404 as such. Rather, they reflect fundamental principles of effective regulation that should guide Congressional action.

III. Fostering Innovation Act

The Committee has requested comment on the Fostering Innovation Act ("FIA"), which relates directly to the foregoing discussion of Section 404. The FIA appears to designate as an "accelerated filer" any company that has more than $100 million in annual revenues or a public float equal to or greater than $250 million but less then $700 million. Currently, accelerated filers include companies with a public of float as small as $75 million. The effect of the FIA therefore would be to remove companies from this category that have $100 million or less in annual revenues or a public float of equal to or greater than $75 million but less than $250 million and accordingly exempt them from compliance with SOXA Section 404(b).

In my view, the Fostering Innovation Act would further undermine the important standards set forth in Section 404, weaken the reputational value of the public company brand in the U.S., and exacerbate the problem of Congressional micromanagement of accounting standards. First, as a matter of good public policy all public companies should be required their auditor to attest to their internal controls.[31] If there are concerns regarding the scope of the required attestation (which Section 404(b) does not itself establish, but rather delegates to the PCAOB), then it is the scope of the audit that should be reformed. Second, it is the smallest companies that are most likely to experience difficulties in this respect. Thus, the FIA exempts from Section 404(b) the companies for which the auditor attestation is

[31] *See generally* Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 Cardozo L. Rev. 703 (2007); *see also AARP Investor Survey, supra* (8 in 10 surveyed investors say auditing standards should be stronger).

most beneficial,[32] which directly contradicts the structure of IPO regulation, for example, where regulatory requirements are heightened for smaller, less seasoned issuers.[33] Third, analysis by academics and regulators has found that the costs of Section 404 compliance have steadily declined since its enactment. A recent, detailed analysis, the SEC's Office of Chief specifically recommended against exempting issuers with up to a $250 million float.[34]

The foregoing points could viewed as policy objections to the FIA. They go to the substantive standards that apply to public companies. There are also broader reasons that the approach taken by the FIA, rather than the policy position it reflects, will weaken the regulation of U.S. securities markets. The following concerns address the broader issue of the efficient operation of administrative law, regardless of its substantive content.

First, the implementation of Section 404, including the scope of any exemptions, should be left to the determination of the regulators that are directly responsible for the administration of that Section's standards and have the appropriate technical expertise. Exemptions created by the FIA, as with exemptions previously created by the Dodd-Frank Act and the JOBS Act, create regulatory unpredictability and inefficiency that increases the costs of regulation for regulators and regulated entities alike.

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[32] *See* Mark Beasley, Joseph Carcello, Dana Hermanson and Terry Neal, *Financial Fraud Reporting 1998 – 2007: An Analysis of U.S. Public Companies* at 10 (2010) (survey of 347 financial fraud cases from 1998 to 2007 finding that companies involved had median revenues of $72.4 million and median stockholders' equity of $39.5 million) *available at* http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.; M.P. Narayanan and J. Nejat Seyhum, *Effect of Sarbanes-Oxley on the Influencing of Executive Compensation* at 10 (March 2006) (both pre- and post-SOXA, smaller firms had substantially greater lags in reporting than larger firms) *available at* http://sitemaker.umich.edu/m.p.narayanan/files/060320replag.pdf

[33] *See Securities Offering Reform*, Securities Act Release No. 8591 (Aug. 3, 2005) (describing tiered approach to regulation depending company size and history).

[34] *See 2011 SEC Study and Recommendations, supra.*

Second, a statutory requirement for the Commission to amend a Commission rule creates significant uncertainty regarding the legal status of the rulemaking. For example, Commission rulemaking is subject to a broad array of statutory mandates, such as the consideration of the costs and benefits of regulation and other regulatory purposes that a rule may serve, that may directly contradict the FIA's rulemaking mandate.[35] The FIA may undermine the ability of the Commission to engage in effective rulemaking and broadly conflicts with the efficient operation of administrative regulation.

Finally, the FIA would further atomize the concept of the public company as a form of investment that provides the markets with a predictable set of default rules regarding for financial reporting. The concept of the "public company" generally reflects the view that companies that sell their shares to retail investors (the Securities Act trigger) or have a large shareholder base (the Exchange Act trigger) should be subject to heightened regulation. The lion's share of the public company regulation entails more rigorous reporting requirements, which reflects Congress's watershed determination in the 1930s that the appropriate primary role of securities regulation should be to ensure that investors have the information they need to make informed investment decisions, rather than to evaluate the substantive merits of investments. However, *ad hoc*, statutory exemptions from reporting requirements, such as the exemptions from Section 404(b) provided by the Dodd-Frank Act, JOBS Act and, possibly, the FIA, threaten to render the concept of "public company" meaningless.

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[35] *See generally* Letter from Fund Democracy, Consumer Federation of America, Consumer Action, AFL-CIO and Americans for Financial Reform, to Elizabeth Murphy, Secretary, SEC (May 24, 2012) (noting that amending Regulation D to permit general solicitation and advertising for private offerings, as required by the JOBS Act, does not relieve the Commission of its obligation to satisfy statutory cost-benefit standards that may militate against the mandated amendment) *available at* http://sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf.

IV. Whistleblower Provisions

In the aftermath of the Enron and Worldcom scandals, Congress was concerned that such "corporate whistleblowers are left unprotected under current law."[36] Whistleblowers such as Enron's Sherron Watkins and Worldcom's Cynthia Cooper played a major role in exposing fraudulent conduct at their companies. Senator Patrick Leahy noted that "when sophisticated corporations set up complex fraud schemes, corporate insiders are often the only ones who can disclose what happened and why."[37] Congress believed that the lack of protection for insiders when they attempt to prevent fraud was:

> a significant deficiency because often, in complex fraud prosecutions, these insiders are the only firsthand witnesses to the fraud. They are the only people who can testify as to 'who knew what, and when,' crucial questions not only in the Enron matter but in all complex securities fraud investigations. Although current law protects many government employees who act in the public interest by reporting wrongdoing, there is no similar protection for employees of publicly traded companies who blow the whistle on fraud and protect investors. With one in every two Americans investing in public companies, this distinction fails to serve the public good.[38]

Congress accordingly enacted Section 806 of Sarbanes-Oxley, which generally prohibits discrimination against employees of public companies (*i.e.*, companies registered or reporting under the Securities Exchange Act) in retaliation for assisting in the investigation of a violation of the federal securities laws. The whistleblower provision has been called "the single most effective measure possible to prevent recurrences of the Enron debacle and similar threats to the nation's

[36] S.Rep. 107-146 at 10 (May 6, 2002).

[37] Beverley Earle and Gerald Madek, *The Mirage Of Whistleblower Protection Under Sarbanes-Oxley: A Proposal For Change*, 44 Am. Bus. L. J. 1, 4 (Spring 2007) (quoting 148 Cong. Rec. S 6,439-440 (daily ed. July 9, 2002) (statement of Sen. Leahy)).

[38] S.Rep. 107-146, *supra*.

financial markets."[39] It is, indeed, an important component of Sarbanes-Oxley's overall approach to combating corporate fraud.

Nonetheless, the First Circuit has held that the employee of a nonpublic company is not covered by Section 806, ***even if the company and its employees are responsible for securities compliance of a public company that is covered by Section 806.***[40] In other words, the whistleblower provision can be circumvented by a public company to the extent that it outsources compliance to a nonpublic company, such as a nonpublic accounting firm. This holding was particularly egregious under the facts of the case because the private company was the investment adviser to a mutual fund. As described below, the unique structure of mutual funds means that, as a practical matter, the ***only*** "employee" to whom the whistleblower provision will apply in relation to a mutual fund's compliance with the federal securities laws is an employee of the fund's investment adviser. Thus, the First Circuit effectively repealed Section 806 for virtually all employees of nonpublic companies who blow the whistle on mutual fund misconduct.[41]

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[39] Richard Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 Wm. & Mary L. Rev. 65, 68 (Oct. 2007) (quoting Taxpayers Against Fraud).

[40] *See Lawson v. FMR LLC*, 670 F.3d 61 (1st Cir. 2012) (Section 806 does not apply to employees of nonpublic companies), *pet. for cert. filed* 81 USLW 3007 (Jun 28, 2012). I have no economic interest in this case, but in the interest of full disclosure I note that I provided compensated expert services to the plaintiffs. This testimony is not intended and should not be read to express any opinion regarding that particular case or any other case.

[41] *See* Rosanne Felicello, *No SOX Whistleblower Protection for Employees in the Mutual Fund Industry According toe First Circuit Decision in* Lawson, 3 Sec. Litig. Rpt. 9 (March 2012) ("The *Lawson* decision is remarkable for the labor that the Circuit Court undertook to reach a result at odds with both the text of the statute and the purpose of the antiretaliatory provisions.. . . the opinion eviscerates any protection for employees in the mutual fund industry, even those employees who work directly with the fund. This is due to the unique set up of the mutual fund industry. The public mutual funds themselves generally do not have any employees (as is the case for the Fidelity funds at issue in *Lawson*). All of the employees who work on the funds are employed by private companies who contract with the mutual fund to provide their services. According to the First Circuit's opinion, none of the employees of the private fund advisers are protected by the whistleblower protection of SOX.").

A mutual fund conducts virtually no securities law compliance activities itself, for it is generally nothing more than a shell comprised of the fund board of directors. Rather, mutual fund compliance responsibilities are assumed almost entirely by the fund's investment adviser. Mutual funds are structurally unique because they typically farm out ***all*** of their service needs to third parties, including compliance. The fund's board of directors negotiates contracts with the fund's service providers and oversees the operation of the fund, but the fund typically does not have any employees;[42] its "employees" are employed by a third-party service provider.[43] As a practical matter, the investment adviser exercises *de facto* control over the fund throughout the fund's life.[44]

The most prominent scandal in the history of the mutual fund industry involved shareholder abuses that were brought to light by precisely the kind of whistleblower to which the whistleblower provision is intended to apply.[45] The

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[42] *Insider Trades During Pension Fund Blackout Periods*, Investment Company Act Rel. No. 25795, at Part II.B(1)(d) (Nov. 6, 2002)) ("[i]nvestment companies . . . typically do not have employees because they are externally managed, with investment advisory and other services provided by affiliated and unaffiliated parties pursuant to contracts with the investment company."); Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute to Jonathan Katz, Secretary, SEC (Dec. 13, 2002) ("Unlike operating companies, investment companies typically do not have employees, . . . The vast majority of investment companies do not have employees because they are externally managed, with investment advisory and other services provided by affiliated and unaffiliated parties pursuant to contracts with the investment company.").

[43] "Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser. . . . the adviser generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors.'" *Investment Company Governance*, Investment Company Act Rel. No. 26323 at Part I (Jan. 15, 2004) (quoting *Burks v. Lasker*, 441 U.S. 471, 481 (1979) (quoting *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976))). As stated by Robert Pozen at the time that he was President and CEO of Fidelity Management and Research Co., the defendant in the First Circuit case: "Virtually all mutual funds are externally managed. They do not have employees of their own. Instead, their operations are conducted by affiliated organizations and independent contractors." Robert Pozen, The Mutual Fund Business, at 22 (1999).

[44] *See* Investment Company Act Rel. No. 26323, *supra* ("a fund adviser is frequently in a position to dominate the board because of the adviser's monopoly over information about the fund and its frequent ability to control the board's agenda.").

[45] *See generally*, Mercer Bullard, *The Mutual Fund as Firm: Fund Arbitrage, Frequent Trading and the SEC's Response to the Mutual Fund Scandal*, 42 Houston L. Rev. 1271 (2006); *see also* Todd Wallack, *Anatomy of a Scandal Anonymous Tip Helped Mutual Fund Regulators Find Where To Dig Up Bodies*,

allegations contained in the complaint that launched the market timing scandal were brought to the New York Attorney General's attention by Noreen Harrington, an executive at Canary Capital Partners.[46] In early 2003, Peter Scannell, an employee of Putnam, reported to the staff at the Securities and Exchange Commission and the Massachusetts Securities Division that, among other things, the investment adviser of the Putnam family of mutual funds and affiliates of the adviser were permitting trading in fund shares that violated fund disclosure documents. In describing his experiences to a U.S. Senate subcommittee, Scannell specifically commended Sarbanes-Oxley's whistleblower provision.[47]

As a general matter, Section 806 should be amended to cover employees of nonpublic companies to the extent that the relevant misconduct relates to a public company's compliance. This amendment is particularly imperative with respect to mutual funds, where an employee of the nonpublic investment adviser is likely to be the ***only*** employee to which Section 806 will ever apply. The trial court,[48] dissenting Appeals Court Judge Ojetta Thompson,[49] Securities and Exchange Commission,[50] and Department of Labor[51] (which has adjudicatory authority over whistleblower complaints) ***all*** disagreed with the two judges who decided the First Circuit case. The Department of Labor's Administrative Review Board has repeatedly held that

San Francisco Chronicle at B1 (Dec. 23, 2003) ("In March, an unnamed whistleblower told Massachusetts securities regulators that Morgan Stanley executives pressured brokers to steer clients toward their in-house mutual funds, prompting both Massachusetts Secretary of State William Galvin and New York State Attorney General Eliot Spitzer to investigate.").

[46] *See* Complaint, *New York v. Canary Capital Partners, LLC* (N.Y. Sup. Ct. 2003).

[47] *See* Testimony of Peter Scannell before the Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate Committee on Government at 17 (Jan. 27, 2004).

[48] *See Lawson v. FMR, LLC*, 724 F.Supp.2d 141 (D. Mass. 2010), *rev'd in part by Lawson, supra.*

[49] *See Lawson, supra* at 83 (Judge Thompson dissenting).

[50] *Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Plaintiffs-Appellees/Cross-Appellants Supporting Affirmance*, 2011 WL 1977769 (Apr. 8, 2011).

[51] *Brief for the Secretary of Labor as Amicus Curiae in Support of Plaintiffs-Appellees/Cross-Appellants Supporting Affirmance*, 2011 WL 1977768 (Apr. 8, 2011)

Section 806 applies to employees of agents of public companies, even if the agent is not itself a public company.[52] Nonetheless, the interests of ensuring securities law compliance as reflected in Section 806 will be frustrated unless Congress takes up the First Circuit's invitation "amend the statute."[53]

V. Option Grant Reporting

One of the most effective provisions of SOXA has been its requirement that insider transactions in issuers' securities, including executive option grants, be reported within two business days of the transaction. Prior to SOXA, stock options grant could be disclosed up to one year after the grant.[54] In contrast, Section 403 of SOXA requires that stock options grants be reported within two business days. This provision has been effective in reducing the practice of fraudulent backdating of stock options, a pervasive practice that was exposed in 2005, when research showed that options backdating was pervasive among public companies.[55] Options that are reported within SOXA's two-day requirement cannot be materially manipulated through backdating.[56] Some have therefore concluded that SOXA

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[52] *See Spinner v. David Landau and Assoc., LLC*, 2012 WL 2073374 at *3 (U.S. Dept. of Labor May 31, 2012) (employee of private accounting firm providing SOX compliance services to public companies are covered by Section 806; citing supporting decisions).

[53] *See Lawson, supra* at 83. Senator Fitzgerald previously proposed such an amendment in Section 116(b) of the Mutual Fund Reform Act of 2004, which clarified that Section 806 applied to employees of an "investment adviser, principal underwriter, or significant service provider" of a mutual fund, regardless of whether the entity was a public company. Section 922(b) of the Dodd-Frank Act amended Section 806 to clarify that it covered employees of nationally recognized statistical ratings organizations (whether or not they are public companies).

[54] *See* Securities Act Rule 16a-3; *see generally* Jesse Fried, *Option Backdating and Its Implications*, 65 Wash. & Lee L. Rev. 853, 882 (2008) *available at* http://www.law.harvard.edu/faculty/jfried/option_backdating_and_its_implications.pdf.

[55] *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 Management Science 802 (2005) *available at* http://www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf.

[56] *See* Narayanan and Seyhum, *supra*.

effectively eliminated the practice of options backdating.[57] Consistent with this view, research shows that patterns suggesting improper backdating did not appear when post-SOXA options were disclosed within one day of the grant date.[58]

However, the same research showed that the disclosure of a large percentage of options has not complied with SOXA; "roughly one-fifth [of executives] violate the two-day reporting requirements."[59] There is substantial evidence that thousands of companies have continued to backdate options while violating the SOXA's two-day reporting requirement,[60] which raises the question of whether the requirement is being adequately enforced.

On the whole, the SEC's options backdating enforcement effort has been extensive. The Commission has brought dozens of enforcement actions related to options backdating[61] including, for example, a case in which it obtained a permanent bar from serving as a director or officer of a public company against a company's former general counsel and chief accountant for, among other things, options backdating and violations of the post-SOXA, two-day reporting requirement.[62]

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[57] *See generally* Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Sep. 6, 2006) (testimony of Christopher Cox, Chairman, Securities and Exchange Commission) (SOXA "slammed the door" on options backdating) *available at* http://www.sec.gov/news/testimony/2006/ts090606cc.htm; *see also* John Zarian, *Backdating Requires Caution, Forethought*, Idaho Bus. Rev. (Oct. 9, 2006) ("The practice of backdating options virtually disappeared in 2002 when the Sarbanes-Oxley Act tightened reporting requirements.") *available at* http://www.stoel.com/files/Backdating_IBR2006.pdf.

[58] *See* Randall Herron and Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants*, 83 J. Fin. Econ. 271 (2007) *available at* http://www.uic.edu/classes/actg/actg593/Readings/Stock-Options/Does-Backdating-Explain-The-Stock-Price-Pattern-Around-Executive-Stock-Option-Grants-Heron,-RA,-E-Lie.pdf.

[59] Herron and Lie, *supra* at 274; *see* Narayanan and Seyhum, *supra* at 4 (finding continued evidence of backdating and late reporting of 24% of option grants).

[60] *See* Fried, *supra* at 883 – 84.

[61] *See* cases listed on the SEC's *Spotlight on Stock Options Backdating* webpage at http://www.sec.gov/spotlight/optionsbackdating.htm.

[62] *SEC Charges Take-Two's Former General Counsel and Former Controller/Chief Accounting Officer with Stock Option Backdating*, Litig. Rel. 21163 (Aug. 3, 2009) *available* at

In addition, reporting compliance may have improved, thereby arguably lessening the need for increased enforcement. None of the data cited above covers reporting during the last 5 years, and I have not found any research that measures more recent options reporting compliance levels. Indeed, some research suggests that SOXA options reporting compliance improved from 2002 to 2004,[63] and such improvement may have continued.

However, it appears that inadequate enforcement may be permitting a significant degree of backdating to continue.[64] The number of enforcement actions involving post-SOXA reporting violations is not consistent with research evidencing thousands of violations during SOXA's early years. And it is not clear why enforcement of the two-day reporting requirement would not be a fairly simple matter. Form 4 is an electronic report that presumably could be searched to generate an automatic red flag when the filing date falls more than 2 days after the grant date. The possibility of creating such an automatic flagging system should be considered (although such a system may already be in place). In addition, it may be appropriate, given the evidence of continued, widespread backdating, to impose automatic penalties for late reporting of options. Penalties could be structured to ensure that they are sufficiently severe that they would not be treated simply as a cost of doing business, such as through higher penalties for repeat offenders.

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http://www.sec.gov/litigation/litreleases/2009/lr21163.htm; *SEC v. Selterman and Tay*, Civ. Act. No. 09-CV-6813 (S.D.N.Y. July 31, 2009) *available at* http://www.sec.gov/litigation/complaints/2009/comp21163.pdf.

[63] *See* Nurayanan and Seyhum, *supra* at 9 (average post-SOXA reporting lag decline from 17.65 to 8.62 days).

[64] *See* Nurayanan and Seyhum, *supra* at 24 ("In order to further restrict [backdating and camouflaged timing], SEC needs to enforce the SOX reporting requirements, and, if possible, limit the use of unscheduled option grants to legitimate purposes.").

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

at

Hearings Before the Subcommittee on Capital Markets and
Government Sponsored Entities

of the

Committee on Financial Services

of the

United States House of Representatives

"The 10th Anniversary of the Sarbanes-Oxley Act"

July 26, 2012
Room 2128 of the Rayburn House Office Building
Washington, D.C.

Chairman Garrett, Ranking Member Waters, and Fellow Members of the Committee:

I. Introduction

I thank you for inviting me. Since the enactment of Sarbanes-Oxley a decade ago, two theories have been regularly at war in legislative debates over financial regulation. Theory One, which certainly underlies the recently enacted JOBS Act, is that our capital markets are buried under an avalanche of overregulation. Theory Two is that our capital markets are suffering from the loss of investor confidence. It is, of course, possible that both theories could be correct to some degree and to different degrees at different times. Nonetheless, I believe that the contemporary evidence far better supports the following generalization: The greatest obstacle to competitive capital markets and job creation today in the U.S. is not overregulation, but the loss of investor confidence.

This loss of investor confidence dates back to the burst of the Internet Bubble in 2000 to 2001. In its wake, investors learned that securities analysts in the U.S. were deeply conflicted. Over the next two years, Enron, World Com and a record number of accounting restatements furthered their disenchantment, and cast doubt over the integrity of audited financial statements. Since then, the IPO market has never returned to its pre-2000 levels of euphoria and volume.[1] The Enron and World Com scandals led, of course, to the passage of SOX a decade ago. Since SOX, it has been possible (and sometimes fashionable) to argue that the reduced number of IPOs is attributable to the regulatory burdens imposed by SOX, but it is even easier (and intellectually simpler) to see the

[1] The IPO market has always been volatile and changes in its volume may partly reflect new waves in technology (such as the Internet revolution that surged in the late 1990s and produced many successful IPOs). This factor could alone explain the reduced number of IPOs. A variety of factors also explain the decline in smaller IPOs of less than $100 million, including the demands of institutional investors for liquidity (which smaller IPOs inherently lack).

reduced level of IPOs as attributable to investor memories that still have not forgotten Henry Blodget, Jack Grubman and Pets.com.

Past bubbles are only one factor in the low level of investor confidence today. Currently, there are much more compelling reasons for increased investor skepticism. To understand this, one only has to survey the recent headlines:

1. The Futures and Commodities Market. The MF Global and Peregrine Financial scandals effectively told clients of futures and commodities brokers that they cannot be certain where their funds are and whether they have been misappropriated. The Peregrine scandal may have continued for 20 years (and thus rivals Bernard Madoff's Ponzi scheme for the length of time that it went undetected). Internal compliance and audit procedures and the segregation of customer funds to have been either lacking or woefully implemented. Other similar scandals could still be buried.
2. The Libor Scandal. The American public now understands that at least some within the largest banks in the U.S. and abroad were eager to collude to fix a critical benchmark rate. Equally important, there is some evidence that regulators (both in the U.S. and the U.K.) were equivocal about stopping this practice. This suggests underregulation, not overregulation.
3. The London Whale. JPMorgan's problems with its Chief Investment Office strike me as more a blunder than a crime, but there is certainly evidence of weak compliance efforts (and there may also be evidence that some traders successfully hid their losses for a time). Worse, the Federal

Reserve Bank of New York had 40 bank examiners on the ground at JPMorgan, but none at its critical Chief Investment Office in London. Like Inspector Clouseau pursuing the Pink Panther, they could not distinguish JPMorgan's headquarters from its hindquarters.

4. Chinese Reverse Mergers. It is estimated that approximately 80 Chinese issuers bought listings on U.S. exchanges between 2008 and 2011 — without conducting an initial public offering under U.S. law.[2] Many of these companies lacked any significant assets or revenues (Sino-Forest was actually listed in Canada, but it has become the symbol of this dubious class of issuers that have streamed into U.S. markets). Investors bought them on overly optimistic hopes for the Chinese economy. Interestingly, Chinese regulators are derisive about the U.S. acceptance of these companies, pointing out that the same companies could not have listed on the major Chinese exchanges. This year, the "Chinese Bubble" has deflated, and the 82 companies listed on the Bloomberg Chinese Reverse Merger Index have declined by some 52% between January 2011, and July 16, 2012.[3] Investors eventually learn — but the lessons are often bitter.

5. Facebook and the U.S. IPO Market. Although IPO markets are always volatile, American investors have lost considerable confidence this year in the domestic IPO market. This is evidenced not only by the much discussed fiasco surrounding the Facebook offering, but by the fact that

[2] See "Chinese Stocks Fleeing U.S.," Market Montage, July 21, 2012.
[3] *Id.*

the IPO pipeline has dried up over recent months and that the stock prices of the other companies in the "social media" industry that recently went public— i.e., Zynga, Groupon, Ren-Ren, and Zipcar[4] — are now trading well below their initial offering prices. Retail investors are angry that reduced analyst forecasts were selectively disclosed to institutional investors but not to them. Again, a bubble has deflated.

6. The JOBS Act. The perception that overregulation is responsible for the decline in IPO volume has strong adherents and was obviously the motor force for the JOBS Act that passed earlier this year. Although I believe that some provisions of the JOBS Act were reasonable in updating or streamlining existing exemptions, I regard other aspects of the JOBS Act as a major retreat from our longstanding commitment to principles of transparency and full disclosure.

What has been the impact of the JOBS Act? Of course, it is too early for any serious assessment. But already there is anecdotal evidence that it is attracting to the U.S. offerings that other markets would not list. The leading example is the approaching IPO of Manchester United, the British soccer team. Other jurisdictions would not permit Manchester United to list "dual class" shares that effectively disenfranchised public shareholders (the shares held by the public in Manchester United will have only one tenth the voting rights per share of the shares held by the control group). The U.S.'s willingness to list shares that do not carry full voting rights plus the exemptions available

[4] For a recent review of the price discounts on these offerings from the time of their IPOs, see Larry Doyle, "Social Media: You Know You're in a Bubble When . . .," Benzinga.com June 19, 2012.

to "emerging market companies" under the JOBS Act appears to have won the U.S. this offering. Nonetheless, it may have been a Pyrrhic victory, and other nations are mocking the U.S.'s success. A recent story in the New Zealand Herald notes that, under the JOBS Act, Manchester United is classified as an "emerging growth company," even though it is 134 years old and has been steadily operating at a loss.[5] A leading Singapore paper has praised the Singapore Exchange ("SEX") for not lowering its standards to those of the U.S.[6]

Should the U.S. be proud of its achievement? The Manchester United offering will not create jobs in the U.S. (as the issuer is a British sports team), but it does suggest that the U.S. is actively competing in a race for the bottom. Perhaps, in the future, some of the Chinese reverse merger stocks that snuck into the U.S. through the back door will instead enter through the front door, now that the JOBS Act has reduced the level of transparency that an IPO issuer must endure. In my view, the U.S.'s success in winning such listings is a dubious honor that will again bring few, if any, jobs to the U.S., but will probably import more than a few frauds. Over the long run, investor confidence will again suffer.

II. H.R. 6161: "The 'Mature Mediocrities' Act of 2012".

[5] See Brian Gaynor, "Why Man U's rules Are Turning It Into a Loser," New Zealand Herald, July 14, 2012.

[6] See Goh Eng Yeow, "Hold IPO Hopefuls to High Standards; Goal of SEX to Attract Brand Names, But They Should Be Actively Traded," The Strait Times, July 9, 2012.

All this brings me to H.R. 6161 (the "Fostering Innovation Act"). It is another proposed step in the headlong retreat from transparency. Equally important, it would be a step that would be taken in the face of a detailed SEC recommendation to the contrary.[7]

Essentially, H.R. 6161 changes the definition of "accelerated filer" in SEC Rule 12b-2 so that companies that are neither "emerging" nor "growth" companies can also escape Section 404(b) of the Sarbanes-Oxley Act (which requires an annual audit of internal controls). Specifically, I have three basic criticisms of H.R. 6161:

First, it goes further than the "emerging growth company" concept of the JOBS Act, because the JOBS Act confers typically only a five year compliance postponement after the date of an issuer's IPO. The JOBS Act's provision can thus be justified as a transitional provision for young companies. In contrast, H.R. 6161 would extend permanent immunity from SOX's Section 404(b) to firms that stayed below $250 million in their "public float" (i.e., their value of stock held by public investors who are not affiliates). Whatever the case for sheltering "emerging growth companies" for a limited period, it is far stronger than the case for immunizing "Mature Mediocrities" forever, as H.R. 6161 would do.

Second, H.R. 6161 goes well beyond what was contemplated by Section 989G of the Dodd-Frank Act because it redefines the term "accelerated filer" (in SEC Rule 12b-2[8]) to require that an accelerated filer must have revenues in excess of $100,000,000 during its most recent fiscal year. The Dodd-Frank Act's Section 989G had contemplated <u>only</u> the possibility of eliminating companies with a modest public float (in the $75

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[7] See Office of the Chief Accountant, U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers With a Public Float Between $75 and $250 Million, (April, 2011).
[8] See 17 C.F.R. 240.12b-2.

million to 250 million range). Under this revised definition in H.R. 6161, a company could have revenues of $90 million and yet have a public float of $600 million (because it had a relatively high price/earnings ratio), and it would not be deemed an "accelerated filer."[9] Such high p/e companies are probably those most needing oversight over the adequacy of their audit controls. In any event, this is a more open-ended exemption than it first appears.

Third, unlike the "emerging growth companies" exemption, H.R. 6161 confers immunity on mature companies that may have a dubious regulatory history. For example, suppose a company with a public float of $200 million had recently experienced a major accounting restatement within the past two years. This sounds like exactly the type of company that needs the oversight of Section 404(b). But it would be exempted because it did not qualify as an "accelerated filer" under H.R. 6161's definition, even if it had experienced multiple restatements and several SEC enforcement actions. My point is that certain "bad boys" should not qualify for this extended exemption.

Finally, there is a likelihood that H.R. 6161's $100 million revenues and $250 million public float tests will be gamed by some issuers. An issuer could defer earnings to the next year to avoid surpassing $100 million in revenues or, even more likely, it (or an affiliate) could buy back stock to stay under the $250 million public float test. The SEC's study reports evidence that issuers do "attempt to avoid Section 404 costs by reducing or managing their public float in order to become or remain a non-accelerated

[9] To illustrate, suppose a company had $90 million in revenues and $20 million in net earnings and the market capitalized its earnings at a 30:1 price to earnings ratio. Its market capitalization would thus be $600 million, but it would still be exempt because it had less than $100 million in revenues.

filer."[10] The possibility of such manipulation is probably greater under H.R. 6161for issuers that are at or near the $250 million float level than for those at or near the $75 million level.[11]

III. The Impact of Section 404(b)

Beyond these narrow drafting comments about H.R. 6161, the broader question of the impact of Section 404(b) deserves a brief comment. Section 404(b) did not on its face require an audit, but it was interpreted to require a full-scale audit before an auditor could attest under Section 404(b) of SOX. In retrospect, that decision could be reasonably debated. In any event, I would have to agree that, as first formulated, Section 404(b) was unduly costly to smaller companies. But that is now ancient history. As the SEC points out in its lengthy study, Section 404(b) was substantially softened and downsized in 2007, and then Dodd-Frank Act's Section 989G exempted all "non-accelerated filers" from its reach. The costs of Section 404(b) compliance have also come down since the 2007 reforms.

Unfortunately, these changes have not ended its death-by-a-thousand-cuts, and the new attempt in H.R. 6161 would exempt roughly another 1,000 companies (according to the SEC's estimate) with a public float between $75 million and $250 million (plus the unknown number of companies with revenues under $100 million and a public float of over $250 million). That would represent another major retreat from the principle of transparency that long governed our market.

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[10] See Office of the Chief Accountant, supra note 7, at 95–96.

[11] This is because, by adding the $100 million revenues test, H.R. 6161 creates an entirely new test that can be gamed. Also, larger issues generally have greater financial resources and hence more ability to buy back or redeem shares.

Equally important, the SEC's study finds strong evidence that Section 404(b) provides meaningful protections to investors. Specifically, the SEC's study reports that:

1. "Section 404(a) and (b) compliant issuers are less likely to issue materially misstated financial statements than issuers not subject to these requirements."[12]
2. "The rate of restatements . . . was 46% higher among issuers that only filed Section 404(a) reports as compared to those that filed auditor attestations under Section 404(b) during the cumulative four years of compliance with Section 404."[13]

On the other side of the ledger, it had been argued that the passage of Sarbanes-Oxley has led to a significant increase in firms going private or "going dark" (i.e., deregistering under the Securities Exchange Act). But here more recent research suggests that Section 404(b) had little or no effect on decisions to go private or go dark.[14] Indeed, debt investors appear to have sometimes demanded that even when firms went private they still had to remain 1934 Act "reporting companies."[15]

This evidence thus suggests that there are benefits to Section 404. To be sure, there are also costs, but smaller companies were spared these costs if they qualified as non-accelerated filers by Section 989G of the Dodd-Frank Act. Now, the issue is whether medium-sized and even larger companies should be able to escape Section 404.

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[12] Office of the Chief Accountant, supra note 7, at 86.
[13] *Id.*
[14] See C. Leuz, Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going Private Decisions, 44 J. Acct. & Econ. 146 (2007); R. Bartlett, Going Private But Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going Private Decisions, 76 U. Ch. L. Rev. 7 (2009).
[15] See Bartlett, supra note 14.

In the wake of the JOBS Act, there is considerable reason to slow the race towards deregulation. We may yet find that in some areas we have gone too far. Nor do we jeopardize our market by moving cautiously. Foreign issuers already have substantially enhanced reasons to consider a U.S. listing (as they can qualify as "emerging growth companies"). The likely beneficiaries of H.R. 6161 will be "Mature Mediocrities," and the case for broadly exempting them in the fashion that H.R. 6161 does has just not been made.

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

WRITTEN TESTIMONY OF

MICHAEL J. GALLAGHER
PROFESSIONAL PRACTICE EXECUTIVE COMMITTEE CHAIRMAN
CENTER FOR AUDIT QUALITY

BEFORE THE
CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE
HOUSE FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

HEARING TO EXAMINE THE BURDENS AND BENEFITS OF THE SARBANES-OXLEY ACT

JULY 26, 2012

Introduction

Mr. Chairman and Members of the Subcommittee, my name is Michael Gallagher and I am pleased to testify today on behalf of the U.S. auditing profession regarding the Sarbanes-Oxley Act of 2002 (the Act). I have more than 26 years of experience in public accounting, and am currently Chairman of the Professional Practice Executive Committee (PPEC) of the Center for Audit Quality (CAQ). I am also the Managing Partner of PricewaterhouseCoopers LLP's audit quality functions.

I am here today on behalf of the CAQ and PPEC. The CAQ was formed in 2007 to serve investors, public accounting firms that audit public companies, and the capital markets by enhancing the role and performance of public company auditors. It is a membership organization with nearly 600 public company audit firms as members. The firms are registered with the Public Company Accounting Oversight Board (PCAOB). The member firms are committed to fulfilling the public interest role that auditors play in our capital markets.

The PPEC supports the CAQ's objectives by providing a forum for public accounting firms to express their views on technical and regulatory matters involving practice before the Securities and Exchange Commission (SEC) and the PCAOB. It also liaises with the SEC, PCAOB, Financial Accounting Standards Board, and others on technical and regulatory matters, including those related to financial reporting and audit quality.

My comments represent the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Overview

Let me begin by providing a brief summary of the objectives, benefits, and costs of the Act, each of which I will explore in greater detail in my testimony.

The Act was passed to restore investor confidence in public companies and enhance investor protection by improving corporate governance and increasing the accuracy and transparency of financial reporting. This subcommittee played an important role in crafting the Act 10 years ago, at a time when the financial markets had been roiled by a series of significant financial reporting frauds, and one of the largest audit firms had gone out of business. Investor confidence had been shaken, and Congress responded in a near unanimous and bi-partisan fashion to improve the accuracy of public company financial reporting, and the quality of public company audits.

We believe the benefits of the Act to investors and the capital markets more broadly have been substantial. In passing the Act, Congress explicitly recognized the interrelated roles that companies, audit committees, and auditors have in assuring the integrity of financial reports. Benefits of the Act include: (i) strengthened audit committees and corporate governance; (ii) enhanced auditor independence; (iii) improved transparency and accountability for financial reporting, in part through new requirements for public companies and their auditors focused on internal control over financial reporting; and (iv) independent oversight of the audit profession by the PCAOB.

These benefits came with certain compliance costs -- costs which are ultimately borne by investors whose confidence had been upset by a series of financial reporting failures. The compliance costs have declined significantly since the Act was first implemented, but nonetheless we understand they need to be considered in the appropriate context when examining the Act.

We believe the Act has been successful in achieving its objectives. In many ways, it has also set new standards for corporate governance and auditor oversight that many other jurisdictions around the world have embraced. Also, we continue to examine ways to build upon the successful reforms of the Act to enhance financial reporting and audit quality and promote greater investor protection. I'll touch upon some of these areas later.

Strengthened audit committees and corporate governance

The Act placed the responsibility for overseeing a public company's financial reporting process and the appointment, compensation, and oversight of its external auditor, with the audit committee rather than management. It requires audit committee members to be independent of management. The audit committee therefore has a responsibility to protect the interests of investors, and auditors report directly to them in their oversight role. This change, which is one of the most important reforms for investors and the capital markets, increased the depth, breadth, and candor of dialogue between auditors and audit committees, improving financial reporting and audit quality.

The Act strengthened audit committees by encouraging them to have at least one member who is a financial expert to serve as a resource to help the audit committee execute its responsibilities. Companies that do not have a financial expert must disclose this in their proxy statement and explain the rationale.

Required communications between auditors and audit committees were enhanced by the Act. They included critical accounting policies and practices and alternative accounting treatments. Audit committees were required to establish procedures for receiving whistleblower complaints, providing another means to identify potential accounting, reporting, and internal control issues and promote improved financial reporting.

Collectively, these changes enhanced the role of the audit committee, empowered it to effectively carry out its responsibilities, and significantly contributed to improved financial reporting and audit quality. Today, proxy filings indicate that audit committees meet with greater frequency than a decade ago, and almost half of all audit committee members are financial experts. This compares to only a small number in 2003[1]. The increase in audit committees' skill sets, coupled with enhanced communications requirements, better enables them to understand and challenge the adequacy and appropriateness of a public company's accounting and

[1] *The Sarbanes-Oxley Act at 10: Enhancing the reliability of financial reporting and audit quality*, Ernst & Young.

financial reporting processes. They also help the audit committee better assess if the auditor has been objective and appropriately skeptical, and whether he or she has performed an effective audit.

Enhanced auditor independence

The Act introduced a number of changes to enhance the independence of public company auditors. We believe these changes were balanced and very effective, and have described them below.

The Act prohibits audit firms from providing certain non-audit services to companies they audit that might compromise their independence. Examples of prohibited services include financial information systems design and implementation, and internal audit outsourcing services. In addition, it requires audit committees to pre-approve all services to be provided by a public company's auditor, including any permissible non-audit services, such as financial due diligence and tax compliance services. Thus, audit committees were empowered to determine which, if any, permissible non-audit services could be performed by the auditor. Transparency also was increased through new proxy statement disclosure requirements that enable investors to see the amount of fees paid by public companies to their auditors for audit and non-audit services.

The Act requires the lead engagement partner to rotate off the audit engagement every five years, rather than seven as had been the case previously under the rules of the profession. It lengthened the "cooling off" period, the period before the partner can return to the engagement, from two years to five years. These requirements were extended to the engagement quality review partner as well, whose role is to perform an objective review of the significant judgments and conclusions of the engagement team.

Conflict of interest rules restricting employment by public companies of former employees of its audit firm's engagement team were also expanded by the Act. In effect, the SEC's rules prohibit a former partner or professional employee of the audit firm who was a member of the audit engagement team from being employed by the public company in a financial reporting oversight role[2] until the audit firm has completed an annual audit without the individual. If the individual is a former partner, he or she may not have a remaining capital balance with the audit firm, and no individual can have a financial arrangement with the audit firm under which payouts would depend on the revenues or profits of the audit firm.

Improved transparency and accountability for financial reporting

Executive Officer Certifications

One of the core elements of the Act was to place clear responsibility for a public company's financial statements with its chief executive officer (CEO) and chief financial officer (CFO). CEOs and CFOs must individually certify that to their knowledge, the periodic financial reports filed with the SEC are materially correct,

[2] Defined in the SEC's final rule regarding auditor independence as a role in which an individual has direct responsibility for or oversight of those who prepare the registrant's financial statements and related information (e.g., management discussion and analysis), which will be included in a registrant's document filed with the SEC.

and that those reports "fairly present" the public company's operations and financial condition in all material respects.

The CEO and CFO must certify that they are responsible for establishing and maintaining an effective system of internal control over financial reporting. Management must evaluate the effectiveness of internal control over financial reporting, and present its conclusion in a report that accompanies the financial statements.

The Act further enhanced executive officers' accountability for financial reporting by mandating stiff penalties -- including forfeiture of bonuses and profits, potential SEC enforcement action, and criminal penalties -- for knowingly certifying non-compliant financial reports.

Internal Control Over Financial Reporting

In addition to requiring management to evaluate and report its conclusion on the effectiveness of internal control over financial reporting, the Act requires auditors to attest to management's conclusion. This requirement has been applied to public companies whose market capitalization exceeds $75 million. We believe these requirements provide significant benefits to investors. They increase accountability of individuals involved in the financial reporting process, enhancing the quality and reliability of companies' financial reporting.

For example, a study released by the SEC in 2009[3] found that the auditor attestation requirement caused management to devote more resources to a disciplined financial reporting process in order to better understand financial reporting risks, implement controls to address those risks, and address control issues in a more timely fashion. That study also noted that an auditor's professional expertise in evaluating internal control over financial reporting provides incremental benefit to management's assessment, and ultimately a benefit to investors, similar to the audit of the financial statements. Other studies have also found that restatements of financial information, an important area of concern to investors, are less frequent for companies subject to the auditor attestation requirement than those that are not[4]. For these reasons, we believe that the discipline and accountability that the auditor attestation requirement provides is very important in today's complex and ever evolving business and financial reporting environment.

The above changes have also led to improvements in the audit committee's role in corporate governance. For example, auditors are required to communicate to the audit committee all significant deficiencies and material weaknesses in internal control over financial reporting that have been identified during the audit. This communication promotes important discussions about internal control over financial reporting among management, the audit committee, and the auditor -- helping improve the audit committee's oversight and the quality of companies' controls and financial reporting.

[3] Section V of the SEC's Office of Economic Analysis *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* found at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.
[4] See http://www.thecaq.org/newsroom/pdfs/CAQCommentLetter-SOX404(b)Study.pdf (page 3).

Independent oversight of public company audits and auditors

The Act established the PCAOB to oversee public company audits and auditors. We believe its activities, and in particular its inspections and standard-setting roles, which were conducted by the auditing profession under a self-regulation model prior to the Act, have been a significant factor in the improvement of audit and financial reporting quality over the past decade.

The largest audit firms are inspected by the PCAOB on an annual basis, while others are inspected at least every third year. The inspection process provides the PCAOB a basis for assessing the degree of compliance by an audit firm with applicable requirements related to auditing public companies. It includes reviews of components of selected public company audits completed by audit firms and the policies and procedures related to certain quality control processes of audit firms, such as those used to monitor audit performance and risks in accepting and retaining clients.

The PCAOB's inspections promote audit quality a number of ways. For example, they reinforce accountability for audit quality at all levels of an audit firm, including leadership. The inspections also highlight opportunities for audit firms to improve. This might include identifying areas on an engagement where more or different audit procedures should be performed. The inspections also help identify areas in which additional training, audit guidance, skills, or communications may be needed.

It is also important to note that the PCAOB's inspection activities are not limited to the U.S. The PCAOB has made significant progress over the past several years reaching inspection agreements with audit regulators in other territories. These efforts are ongoing, and US regulators are seeking to obtain better alignment in those cases where US and local territory laws conflict. Thus, international inspections also promote investor protection, particularly in light of the ever increasing complexity and global scale of business. Many jurisdictions have adopted similar independent auditor oversight models.

Standard-setting can also have a significant impact on audit quality. The PCAOB publishes its standard setting agenda, and solicits feedback, in part, through its Standing Advisory Group (SAG). The SAG comprises investors, public company executives, audit committee members, auditors, and other stakeholders. I am a member of the SAG, as are several other individuals in the member firms of the CAQ. Also, the CAQ, including the PPEC, works closely with the PCAOB and its Staff on new and emerging auditing issues, with a focus on promoting standards that enhance financial reporting and audit quality.

Costs of the benefits

We recognize the aforementioned benefits associated with the Act came with certain costs of compliance, costs which have generally declined over the last ten years[5]. In fact, a July 2012 report by Audit Analytics found that in 2011, audit fees, as a

[5] Protiviti's *2010 Sarbanes Oxley Compliance Survey* can be found at http://www.auditnet.org/articles/KL201010.pdf.

percentage of public company revenues, were at the lowest level since 2004, the first year of the Act[6].

In order to put the above in context, it is helpful to consider how the Act's implementation has evolved over time. The PCAOB's original auditing standard on internal control, issued in 2004, was widely viewed as being too rules-based and costly, as audit hours, audit fees, and companies' associated internal costs increased significantly. The PCAOB recognized these concerns and responded by issuing a revised standard in 2007 that was intended to promote a more risk-based audit and was less prescriptive, thereby allowing the use of more auditor judgment. While focused on maintaining audit quality, that standard generally resulted in reductions to the nature and extent of audit procedures, and a corresponding reduction in audit hours and fees[7].

The PCAOB also published staff guidance on its revised standard for audits of smaller public companies[8]. This guidance was intended to facilitate more efficient and effective audits of internal control over financial reporting for smaller, less complex public companies. The PCAOB conducted forums across the country for auditors of smaller audit firms, to help address implementation issues associated with its revised standard.

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[6] Audit Analytics' *Audit Fees and Non-Audit Fees: A Ten Year Trend*, July 2012 (page 3).
[7] http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.
[8] PCAOB Staff Views *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements Guidance for Auditors of Smaller Public Companies.*

The SEC also undertook targeted reforms that resulted in more efficient and effective implementation of the internal control requirements of the Act. It released guidance in 2007 for companies to use in their assessments of internal control[9]. This guidance improved management assessments, which has contributed to an increase in auditor efficiency.

In addition, the recently passed Jump Start our Business Startups Act (JOBS Act) also provides certain relief to emerging growth companies, including a temporary exemption from the auditor attestation on internal control over financial reporting. While we believe that the auditor attestation requirement enhances investor protection, we understand the cost/benefit balance achieved by providing emerging growth companies additional time to comply with it.

Aside from actions by Congress, the PCAOB, and the SEC, other factors have contributed to the downward trend in costs related to the internal control requirements. For example, as the work of auditors and public companies in this area has evolved over the years, there continue to be efficiencies gained by both. Management's processes and activities that support a public company's required assertion about internal control over financial reporting have become more integrated with their day-to-day activities and related financial reporting, in part due to investments to update information technology systems. Further, auditors have

[9] SEC *Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934.* http://www.sec.gov/rules/interp/2007/33-8810.pdf

made continued progress in integrating their audits of internal control over financial reporting with their financial statement audits.

Thus, the collective impact of these factors has led to a general decline in compliance costs associated with the internal control provisions of the Act.

Continuous improvement

Often the only time the investing public hears about a significant financial reporting or auditing issue tends to be when the financial reporting system has not worked as it should, whether it is a restatement of the financial statements, an audit deficiency, or other matter. We believe the accountability and transparency provided by the Act has been a significant deterrent to potential wrong doers. Also, in some respects, investors do not hear anything when the system works and delivers the value that was intended, which is the case the vast majority of the time - - issues are identified and fixed, internal controls are improved, and auditor performance and audit committee oversight are effective.

That said, the auditing profession is constantly looking for ways to make the system better, with appropriate consideration of cost/benefit. Accordingly, we are actively engaged in the dialogue with investors, audit committees, regulators and others on ways to further enhance financial reporting and audit quality. For example, the CAQ has been supportive of a number of the PCAOB's recent proposals, including making improvements to the auditor's reporting model and audit committee communications. We also support looking for ways to have more meaningful conversations with audit committees about PCAOB inspection findings for a given engagement. Further, the CAQ is working with the audit committee community to identify what auditors can do to promote best practices for audit committees as they execute their responsibilities.

Closing

To briefly recap, we believe the Act has achieved its objectives, and that the benefits to investors and the capital markets more broadly are substantial. It (i) strengthened audit committees and corporate governance; (ii) enhanced auditor independence; (iii) improved transparency and accountability for financial reporting; and (iv) established independent oversight of the audit profession by the PCAOB.

Though the significant benefits achieved did include certain compliance costs, those costs have generally declined over the past 10 years, in part due to additional experience and process improvements by public companies and their auditors, and other actions.

Lastly, we believe that the best course looking forward is to build upon the successful reforms of the Act. We commit to fulfilling our role by engaging investors, audit committees, regulators, and others on this subject with a clear focus on enhancing investor protection.

Thank you. I would be happy to take any questions you might have.

Biotechnology
Industry
Organization

Jeffrey S. Hatfield

President and Chief Executive Officer,
Vitae Pharmaceuticals

On behalf of the Biotechnology Industry Organization

Before the United States House of Representatives Committee on Financial Services,
Subcommittee on Capital Markets and Government Sponsored Enterprises

"The 10th Anniversary of the Sarbanes-Oxley Act"

July 26, 2012

Executive Summary

- Vitae Pharmaceuticals is a clinical-stage biotechnology company based in Fort Washington, Pennsylvania. The Biotechnology Industry Organization (BIO) represents Vitae and more than 1,100 innovative biotechnology companies, along with academic institutions, state biotechnology centers, and related organizations in all 50 states.
- BIO supports H.R. 6161, the Fostering Innovation Act, which would amend the filing status classifications in SEC Rule 12b-2 to provide a more accurate picture of growing businesses.
  - The bill would raise the minimum public float requirement for accelerated filers to $250 million, allowing non-accelerated filer start-ups to expand and change without fear of impeding their growth with costly regulations.
  - The bill would add a revenue component to the accelerated filer definition, ensuring that companies with revenue below $100 million spend their critical innovation capital on groundbreaking research and development rather than regulatory burdens.
- It can take more than a decade and over $1 billion to bring a single biotechnology therapy from laboratory bench to hospital bedside.
- Biotech companies undertake the development process without the benefit of product revenue. Every dollar spent on regulatory compliance is an investment dollar diverted from innovation.
- Biotech companies have few employees, a simple corporate structure, and investors that are more concerned with clinical milestones than financial reporting. The cost of regulatory compliance often outweighs its benefit.
- Public company regulatory requirements deter early-stage private investors and prevent later-stage companies from accessing the capital available on the public market.
- The costs of Sarbanes-Oxley Section 404(b) compliance can be greater than $1 million per year for an average biotech company. These costs are borne at the expense of research and development.
- The SEC Rule 12b-2 filing status classifications that determine public company regulatory requirements are outdated and do not accurately represent the true nature of smaller companies.

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Testimony of Jeffrey S. Hatfield

Good morning Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee. My name is Jeff Hatfield, and I am the President and Chief Executive Officer of Vitae Pharmaceuticals in Fort Washington, Pennsylvania. I am also a member of the Emerging Companies Section Governing Board at the Biotechnology Industry Organization (BIO). I want to thank you for the opportunity to speak with you today about the unique hurdles that biotechnology companies face in their search for groundbreaking medicines and how finding the important balance between regulations that protect investors and regulatory burdens that stifle growth is key to speeding the delivery of cures and treatments to patients who desperately need them.

Vitae's experience is emblematic of a typical emerging biotech company. The long development period intrinsic to the groundbreaking research that we do means that it can take a decade to bring a therapy from laboratory bench to hospital bedside – and often, as in Vitae's case, it takes much longer. Our company was founded in late 2001, and we have spent the past ten years working toward treatments to some of the most widespread and devastating diseases that the world faces, including diabetes, Alzheimer's, atherosclerosis, and chronic kidney disease. Our lead product, a compound designed to preserve kidney function by inhibiting damage-causing renin, just completed Phase I clinical trials. Although we are optimistic about its progress, and that of the rest of our development pipeline, we expect to be in clinical trials for at least another four to six years before moving on to the approval process at the FDA. Quite simply, developing a novel therapy is a long, difficult process – but the results can save lives. Entrepreneurs across the biotech industry are conducting groundbreaking science like ours, and are deeply invested in treating the severe illnesses that families around the nation and world face.

The story of biotech drug development is one of advancement. As a given molecule moves through the development process, it requires an ever increasing amount of resources to progress the drug candidate closer to a stage where it could save a patient's life. From the initial discovery in the lab and basic toxicology research to early Phase I studies and, eventually, sweeping Phase III trials to determine efficacy – the science involved gets ever more complex, and the clinical stakes get higher as companies move closer to a cure. However, while the science is increasingly intricate, our corporate structure remains essentially the same. After all, over 90% of biotech companies have fewer than 100 employees.[1] Vitae has just 55. As scientists, we are innovators expanding the world's understanding of human life. As a corporation, we strive to stay as simple as possible so that the maximum amount of investment dollars can flow directly to our R&D.

This efficiency is extremely important given the massive amount of funding required to develop a biotechnology treatment. The extended development period and groundbreaking science require over $1 billion to bring a single therapy to market. Further, the entire process is undertaken without the benefit of product revenue. Early-stage biotech companies do not have the luxury of using the sale of one product to finance the development of another. Rather, the entire cost of drug development is borne by external investors. These funds can be raised in any number of ways – seed financing from an angel investor could lead to increased investment from venture capitalists, a larger pharmaceutical company could offer a partnership opportunity, or public financing via the IPO market might be the appropriate avenue for a given firm. Most companies use some combination of financing methods to continue their research. But the common message from all investors is the utmost importance of using their funds efficiently. Companies and

[1] BIO Emerging Companies Section Membership Survey, 2011.

investors alike understand this key aspect of the biotech business model – because investment dollars go directly from the investor to the lab, any diverted funds are, by definition, lost to innovation. And any delay in innovation has a corresponding delay in the delivery of new medicines to patients who need them.

The efficient use of investment funds has always been imperative for biotech companies, but it has taken on increased import given the current financing environment. In 2011, the total number of investment deals between biotech companies and venture capitalists dropped 8%,[2] and a recent National Venture Capital Association (NVCA) study found that 41% of VCs decreased their investments in the biopharma sector over the last three years.[3] This trend has hit small companies the hardest, as the number of start-ups receiving funding in 2011 dropped 19% from 2010. Further, there were only 98 first round venture deals with biotechnology companies in 2011, a significant drop from the industry's peak of 141 in 2007.[4] Small, start-up companies are the innovative heart of our industry, but depressed financing means that potential cures and treatments are often left on the laboratory shelf.

Biotech companies considering the public market are also facing a decline in capital availability. In 2011, there were only eight IPOs of venture-backed biotech companies. Those IPOs raised $517 million, down from the $1.2 billion raised in 2007 by 19 IPOs.[5] Although the industry is slowly recovering from its recession-induced nadir (in 2008 there was only one biotechnology IPO), this progress has been made almost entirely by larger, more mature companies. These more established companies are getting better deals and emerging companies making their first forays onto the public market are getting squeezed out. Small companies that do manage to make it onto the public market often face an underpriced IPO and a lack of liquidity.

These private and public financing problems are not independent of one another. A significant reason for reluctance in venture investing has been the inaccessibility of the public markets. Venture capital investors need to know that they will have an exit through which they can get a return on their investment; often, they look for this exit when a company files for an IPO. With companies reluctant to go public, venture capital firms are turning elsewhere to make their investments, leading to a dearth of innovation capital for biotechnology.

Given the increased difficulty of obtaining essential funding, the efficient use of capital is of utmost importance. Regulatory burdens that impose significant costs, then, have become increasingly damaging. In a 2011 survey conducted by the IPO Task Force, 86% of CEOs cited "accounting and compliance costs" and 80% cited "SOX and regulatory risks" as key concerns about going public.[6] Biotech companies that would otherwise look to the public market to fund their late-stage trials are reconsidering, fearful of the costly regulations that often stifle their progress by siphoning off research dollars.

The Sarbanes-Oxley Act of 2002

This coming Sunday will mark ten years since the Sarbanes-Oxley Act (SOX) was signed into law by President Bush. Enacted as a response to scandals at Enron and WorldCom,

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[2] NVCA/PWC MoneyTree Report: Q4 2011. Data provided by Thomson Reuters.
[3] NVCA and MedIC. "Vital Signs: The Crisis in Investment in U.S. Medical Innovation and the Imperative of FDA Reform." October 2011.
[4] Inside BIO Industry Analysis. "Venture Capital increases in 2011, but..." 24 January 2012.
[5] Rockoff, Jonathan D. and Pui-Wing Tam. "Biotech Funding Gets Harder to Find." *Wall Street Journal*. 16 March 2012.
[6] IPO Task Force. "Rebuilding the IPO On-Ramp." October 2011.

among others, SOX seeks to protect investors through greater transparency. I support this goal. Large, multi-national corporations have thousands of investors and a complicated corporate structure that can be obdurately opaque to an outside observer.

In the biotech industry, an informed investor is a good one. However, the information that these investors want and need does not always align with what is required by SOX. Section 404(b) requires an expensive external attestation of a public company's internal controls, to be disclosed to investors on an annual basis. The true value of a biotech company is found in scientific milestones and clinical trial advancement toward FDA approvals rather than financial disclosures of losses incurred during protracted development terms. The business model of biotechnology is simple – we take in millions of dollars to fund our research and often do not earn a single penny in product revenue for more than a decade. Our science is the interesting part of our business, and it is the most important thing for investors to understand. Investors make their decisions based on scientific results and development milestones, not the statements and reports mandated by Section 404(b). Thus, the financial reporting required does not provide much insight for potential investors, meaning that the high cost of compliance far outweighs its benefits.

In fact, spending capital on regulatory burdens can actually slow the development process, increasing the time it takes to reach the important milestones that trigger new investments. Without product revenue, biotech companies on the public market are forced to ask investors to pay for SOX reporting rather than scientific research. The cost burden of these regulations, and therefore the amount of capital diverted from R&D, is significant. In 2011, an SEC study found the costs of Section 404 compliance to be nearly $1 million for companies with a public float between $75 million and $250 million.[7] We have done internal analysis at Vitae and arrived at a similar figure – if we decided to go public, it would cost us roughly $1 million annually to comply with SOX Section 404(b), to say nothing of the steep learning curve, and corresponding costs, that the first few years of compliance would entail. For a company with just 55 employees, compliance would cost nearly $20,000 for each person on our staff. This cost would be borne entirely by our investors.

Congress has taken some steps to relieve the cost of this regulatory burden. In 2010, Dodd-Frank provided a permanent exemption from Section 404(b) compliance for non-accelerated filers, those with a public float below $75 million. This change was welcome, and has allowed the smallest of companies on the public market to escape the costs of SOX. More recently, Congress passed the JOBS Act, providing emerging growth companies five years to transition onto the public market, during which time they are exempt from 404(b) compliance provided their revenues remain below $1 billion and their public float stays under $700 million.

This five-year exemption, in combination with the other regulatory allowances provided by the JOBS Act IPO on-ramp, is already proving alluring to growing biotech companies. Since President Obama signed the JOBS Act into law on April 5, 46 companies have taken the step toward the public market as an emerging growth company, either by filing a new S-1 or by taking advantage of the provision's retroactivity to December 8, 2011 and submitting an S-1/A to amend their existing filing. Of those 46 filers, 12 were biotech companies.[8] Further, I understand that many other companies are taking advantage of the confidential filing process made available by the JOBS Act. The fact that over a quarter of the emerging

[7] SEC, Office of the Chief Accountant. "Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers With Public Float Between $75 and $250 Million." April 2011.
[8] Analysis of post-JOBS S-1 and S-1/A filings. This data only includes companies which have filed publicly. The JOBS Act contains a provision allowing emerging growth companies to file a confidential draft registration statement with the SEC; the confidential nature of those S-1s makes them impossible to track.

growth companies that have filed publicly are from the biotech industry shows both the desire of growing biotechs to access the capital available on the public market and their reluctance to do so in the face of costly regulatory burdens.

While the five years of non-compliance in the JOBS Act will provide an easier transition period post-IPO, it remains the reality that the biotech development period is much longer than five years, and that small biotech companies will still be without product revenue after the on-ramp expires and SOX compliance kicks in. They will then be forced to ask their investors to pay for bureaucratic red tape rather than innovative research. Further, the JOBS Act did not address the needs of companies that are currently on the public market. These companies are already complying with Section 404(b), with no relief in sight. The cost of this compliance is millions of dollars of diverted funds for the company, and delayed medical breakthroughs for patients.

H.R. 6161, the Fostering Innovation Act

Rep. Mike Fitzpatrick has introduced legislation to relieve smaller companies of the cost burden caused by Sarbanes-Oxley and other onerous regulations. H.R. 6161, the Fostering Innovation Act, would amend the filing status classifications in SEC Rule 12b-2 to provide a more accurate picture of the growing businesses that are weighed down by the various reporting requirements obligatory for public companies.

Rule 12b-2 establishes three distinct classifications by which public companies determine their filing status. A company's filing status carries with it a designation of its regulatory burden, designed to increase as a company gets larger and more complex. The filing status classifications are defined in terms of a company's public float:

- large accelerated filers – companies with a public float of more than $700 million;
- accelerated filers – those with a public float of more than $75 million but less than $700 million; and
- non-accelerated filers – companies with a public float of less than $75 million.

Because the filing statuses for accelerated and large accelerated filers carry with them onerous regulatory duties and compliance costs, finding a method of designation that fairly captures a company's profile is essential. The SEC understands that there should not be a one-size-fits-all approach to public company regulation, but the current filing classifications are outdated and do not reflect the true nature of many small public companies.

Despite their simple corporate structure and lack of product revenue, many biotechs have a relatively high public float. Although Vitae is still private, we believe that if we filed for an IPO our public float could be in the $75 million to $250 million range that the SEC studied in 2011, as mandated by Dodd-Frank. Biotechs often find themselves grouped with the accelerated filers and obliged to comply with the numerous regulatory burdens attendant to that definition, including SOX.

Rep. Fitzpatrick's bill would raise the minimum public float requirement for accelerated filers to $250 million, classifying companies with public floats below that level as non-accelerated filers. This increase from $75 million to $250 million would allow start-ups to expand and change without fear of impeding their growth with costly regulations. Many biotechs have public floats in or near that range, and the flexibility provided by H.R. 6161 would allow them to focus on their innovative research rather than shifting funds to compliance costs.

The Fostering Innovation Act would also add a revenue component to the accelerated filer definition. Under the bill, accelerated filers would be described as those with revenues in excess of $100 million. Thus, any company with revenues below $100 million, regardless of public float, would be considered a non-accelerated filer. As I have mentioned, the most damaging facet of SOX for the biotech industry has been the diversion of investment funds from science to compliance in the absence of product revenue. Rep. Fitzpatrick's bill reflects this reality by classifying low-revenue companies as non-accelerated filers. If enacted, H.R. 6161 will ensure that critical innovation capital is spent on groundbreaking research and development rather than regulatory burdens.

Complying with non-accelerated filer standards rather than those required of accelerated filers would provide tremendous relief for growing companies. The exemption from SOX Section 404(b) alone would save innovative start-ups millions of dollars. Additionally, non-accelerated filers have a relaxed timeline for their quarterly disclosures because their small size and lack of a large compliance department make the filings more onerous – attributes shared by biotech companies currently in the accelerated filer bucket. Non-accelerated filers also enjoy certain allowances within those filings, including exemptions from Compensation Discussion and Analysis (CD&A) reporting, the elimination of certain disclosures about market risk and other risk factors, and exclusions for some financial data. These changes would allow small biotech companies to focus on their mission of delivering cures and treatments to patients who need them rather than time-consuming and costly reporting.

The regulatory allowances in H.R. 6161 would not extend to accelerated or large accelerated filers. The bill maintains the important investor protections required of these large companies while recognizing the simpler corporate structure of non-accelerated filers. Updating the filing status definitions in Rule 12b-2 would reflect the true nature of small public companies while maintaining important requirements for larger corporations. New definitions would group companies with common characteristics together, giving the SEC more accurate classifications and providing important regulatory relief to innovative startups.

Public Company Accounting Oversight Board (PCAOB)

Section 404(b) compliance for small public companies has received the bulk of the attention paid to Sarbanes-Oxley in the ten years since its enactment, but the law contained much more than this one provision. Notably, Title I of SOX established the Public Company Accounting Oversight Board (PCAOB). Better alignment of the interests of shareholders with the interests of independent audit committees and oversight authorities was an important objective of SOX.

I do believe overall audit quality has been improved as a result of PCAOB inspections and standard-setting. However, there are other areas of concern in which potential PCAOB action could place additional undue burdens on small public companies.

Last August, the PCAOB issued a concept release on auditor independence and asked for public comment on mandatory audit firm rotation. The concept release suggested that requiring public companies to change audit firms periodically would increase independence and skepticism in the audit report. However, I believe such a requirement could result in a prohibitive added cost to the public company, with very little added benefit to the investor. Increased audit fees, combined with a steep learning curve for each new audit firm, would greatly increase the cost burden on growing companies. Biotech companies in particular would bear the brunt of the proposed changes, as there are relatively few audit firms that are familiar with our industry. Increased costs combined with an extended transition period to bring a new firm up to speed would distract from and delay the search for cures and treatments.

Additionally, the PCAOB issued another concept release last year to revise the standard audit report to include more information. While I do not object to the principle proposed, it is important to prevent such a requirement from placing significant increased liability on the auditor, thus greatly increasing costs for small public companies.

It is important to note – especially when debating the value of 404(b) compliance – that SOX did enhance corporate accounting in many ways. Sarbanes-Oxley took necessary steps to combat corporate accounting fraud by boosting penalties for such white-collar crime. I believe these steps aided in restoring investor confidence and continue to help weed out corporate bad actors. That said, as we acknowledge the ten year anniversary of SOX, Congress has the opportunity to reexamine which parts of the Act continue to provide important investor protections and which are driving businesses away from the United States through costly overregulation.

Closing Remarks

The biotechnology industry is a significant economic growth engine, directly employing 1.6 million Americans and supporting an additional 3.4 million jobs.[9] The goal of our industry is to find and deliver cures for the devastating diseases that each of us – personally or among families and friends – will likely have to face. But there are tremendous challenges to overcome. One of the most significant for the broad array of small companies that make up the biotech industry is funding the extremely high cost of conducting research. It forces us to be very efficient and careful with each dollar we are able to attract from investors.

When regulatory requirements exceed or do not align with the primary needs of the public or investors, that regulation becomes an unnecessary expense burden, meaningfully and directly subtracting from the investment capital driving the discovery and advancement of potential scientific breakthroughs. Some of the regulatory requirements imposed by Sarbanes-Oxley fit that definition. Those regulations increase bureaucracy and operating costs for biotech companies, taking away money from research, blocking job creation, and slowing the overall development of science in our labs. If Congress can relax this regulatory burden on small companies like those found in the biotech industry, it will allow innovators and entrepreneurs to continue working toward delivering the next generation of medical breakthroughs – and, one day, cures – to patients who need them.

[9] Battelle/BIO State Bioscience Industry Development 2012. Battelle Technology Partnership Practice, June 2012.

financial executives international

www.financialexecutives.org

Testimony of Marie N. Hollein, CTP

President and Chief Executive Officer

Financial Executives International

Before the

Subcommittee on Capital Markets

and Government Sponsored Enterprises

Committee on Financial Services

U.S. House of Representatives

On the Topic of

The 10th Anniversary of the Sarbanes-Oxley Act

July 26, 2012

Prepared Testimony to the Subcommittee on Capital Markets and Government Sponsored Enterprises

By Marie N. Hollein, CTP

President and Chief Executive Officer, Financial Executives International

On Behalf of Financial Executives International

July 26, 2012

Good morning Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am pleased to testify before you today concerning "The 10th Anniversary of the Sarbanes-Oxley Act," which continues to impact members of the organization I lead, Financial Executives International.

FEI is a professional organization of 15,000 senior-level financial executives -- including chief financial officers, controllers, treasurers, and tax executives -- from more than 8,000 private and public companies, across all industries.

FEI provides a unique forum for senior-level financial executives, and its mission incorporates what we refer to as the "4 I's":

- Interaction;
- Information;
- Influence; and
- Integrity

These pillars are paramount for FEI members, and serve as our policymaking roadmap in Washington.

Integrity is not only the bedrock for our organization; it is the necessary first principle for effective markets. From families saving for retirement to professionals managing billions of dollars, every investor depends on accurate and reliable financial reporting. Without the trust that comes with market integrity and sound corporate governance: investors withdraw, capital markets wither, companies cannot grow and jobs become scarce.

Ten years ago, after corporate scandals began to damage investor confidence in this country, Congress passed Sarbanes-Oxley. Today, with the benefit of hindsight and history, we have an opportunity to examine what has worked in the realm of corporate governance, and how we might do better in the future.

In my statement today, I will cover four issues:

- FEI's role in Sarbanes-Oxley;
- The costs and benefits of the law;
- How it compares to Dodd-Frank; and
- Other on-going, anti-fraud initiatives.

Over the course of the Sarbanes Oxley debate, FEI offered several recommendations that Congress eventually adopted into the legislation, these included provisions concerning auditor independence, whistleblowers, the creation of the PCAOB and the addition of a financial expert to companies' audit committees. FEI also recognized that while the vast majority of financial executives conduct themselves with unwavering integrity, because of our special role in corporate governance, our members need to adhere to a specialized code of ethical conduct. This recommendation resulted in the requirement that a company's CEO, CFO and/or CAO certify the firm's financial statements.

The requirement that CEOs personally certify their company's financial statements is the crown jewel of Sarbanes-Oxley. This personal responsibility sets the tone at the top, increasing accountability and driving better corporate governance.

After its passage, even ardent supporters of SOX acknowledged portions of the law were costly and time-consuming. The vast majority of financial executives found the initial SEC and PCAOB rules implementing SOX were overly prescriptive. The SEC and PCAOB incorporated this feedback into subsequent rule-makings, which FEI appreciates.

Attempting to measure the cost of SOX, FEI has annually conducted an Audit Fee Survey. We found that for public companies who responded to our survey regarding their audit fees for the year 2011, on average, fees continue to rise 5% from the prior year, to $4 million per company. Clearly, the cost of compliance continues to grow.

Sarbanes-Oxley has clearly increased audit fees and the hours devoted to audits for our members. But, our members are now facing additional costs on a much greater scale stemming from Dodd-Frank. When comparing these two laws, Dodd-Frank trumps Sarbanes-Oxley in size and scope, but also in the sheer number of rules that even non-financial companies must comply with. SOX required only 14 new SEC rules, whereas Dodd-Frank requires the SEC to tackle 100 new rulemakings.

Remember, most of our members work for Main Street, not Wall Street, businesses. Yet even for them, the Volcker rule carries liquidity impacts. And, derivatives regulation is likely to increase costs and hinder risk management practices for senior-level financial executives in every industry.

With respect to H.R. 6161 offered by Congressman Fitzpatrick, while FEI currently does not have a position on the bill, a number of our members' companies would benefit from the increase in reporting flexibility it provides.

As we look back at older laws, and consider new ones, it is important to remember that new laws and regulations are not the only path to better markets. FEI also believes strongly in 'stepping up' to the plate to research, improve and share best practices in deterring and detecting fraud. For example:

- FEI is one of the five founding members of COSO, the Committee of Sponsoring Organizations of the Treadway Commission. Currently, COSO is updating its *Internal Control – Integrated Framework* which is widely utilized by auditors in examining a company's internal controls and ensuring their effectiveness.

- FEI is also a member of the Anti-Fraud Collaboration. The collaboration draws on expertise from across the financial reporting supply chain, and sponsors anti-fraud education and projects for the profession.

Ensuring market integrity is at the center of each of our efforts, and the goal of all of us in this room today. Thank you for the opportunity to address you this morning. I look forward to your questions on these and other topics.

The Institute of Internal Auditors

Statement of

The Institute of Internal Auditors

House Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

"The 10th Anniversary of the Sarbanes-Oxley Act"

Chairman Garrett, Ranking Member Waters and members of the Subcommittee:

The Institute of Internal Auditors (The IIA) is pleased to submit this written statement for the record in connection with this important hearing.

The IIA is the internal audit profession's global voice, acknowledged leader, chief advocate, and principal educator. As the profession's recognized authority, The IIA has actively supported its members in their role of assisting organizations implement and execute the requirements of the Sarbanes-Oxley Act (Sarbanes-Oxley). We appreciate the chance to provide Congress with our perspective on the importance of strong corporate governance, risk management and internal controls as enhanced by Sarbanes-Oxley as it relates to financial reporting.

Established in 1941, The IIA is the sole recognized world leader in certification, education, research, standards and guidance for the internal audit profession. The IIA's more than 175,000 global members (of which over 63,000 are in the United States) work across a wide range of disciplines, including internal auditing, risk management, governance, internal control, information technology audit, education, and security. The IIA is dedicated to supporting quality, professional, and ethical practices across all industry sectors as well as public enterprises, providing internal audit practitioners, executive management, boards of directors, and audit committees with guidance designed to enhance governance, risk management and control. We are engaged with many government, professional and standard setting bodies around the world as they all pursue enhancing organizational governance, risk management, and control activities.

The Sarbanes-Oxley Act was designed, among other things, to improve corporate governance and restore investor confidence in the wake of notable scandals such as Enron and WorldCom. The legislation included a number of reforms intended to, for example, improve the reliability of corporate financial reporting. Sarbanes-Oxley helped achieve this by establishing oversight of public company audits, requiring certification of financial statements by the chief executive officer (CEO) and chief financial officer (CFO), and requiring greater independence from audit committees and auditors. As we approach the tenth anniversary of this landmark legislation, The IIA believes such legislative reforms, while never perfect, have brought key financial reporting matters to the

The Institute of
Internal Auditors

forefront of corporate consciousness and have resulted in meaningful improvement in the disciplines associated with the integrity of reported financial data and related operating results. Internal audit plays a significant role in overall corporate governance. The IIA believes the four cornerstones of effective corporate governance are the Board of Directors (supported by a well qualified audit committee), executive management, internal audit, and external auditor. When these governance cornerstones work effectively, internal controls are enhanced, reporting has greater integrity, ethics are stressed, oversight is improved, risks are more effectively identified and mitigated, and, most importantly, investor confidence can be restored and maintained.

Since Sarbanes-Oxley was enacted, these cornerstones have been improved, as companies have become more transparent and vigilant in managing and mitigating the risk of inaccurate or fraudulent financial reporting. In so doing, many companies have significantly enhanced their understanding of key risks and controls surrounding the financial reporting process. The IIA agrees that effectively mitigating risk and having appropriately robust control processes around financial reporting is paramount and should be a major priority for board and audit committee members as well as executive management.

Good organizational governance is simply good business. Sarbanes-Oxley, while not perfect, has created a foundation for the future of corporate governance and internal controls in support of financial integrity and reporting. There are many who can and will, appropriately, debate the benefits and burdens resulting from the Sarbanes-Oxley legislation. Many will also say that you can never legislate ethics, with such legislation only making already ethical people work harder. However, in the end, the responsibilities and accountabilities placed on Corporate America as a result of Sarbanes-Oxley, on the whole, have made a positive impact. We applaud this subcommittee's activities to assess the impacts of Sarbanes-Oxley at its one decade anniversary. Like any piece of significant legislation, there likely remain opportunities to better focus some aspects of the legislation and related regulations, clarify its intent, and reduce the associated costs. We would be honored to be an active participant in future conversations and debates as this topic progresses.

Today, more than ever, internal auditing is critical to strong corporate governance. As noted by Carlo di Florio, Director of the Securities and Exchange Commission Office of Compliance Inspections and Examinations, the financial crisis should serve as a reminder of the fundamental need for stronger ethics, risk management, and regulatory compliance practices to prevail. The IIA believes every organization, regardless of size, benefits from a fully resourced and professionally competent internal audit staff that provides value-added services critical to efficient and effective organizational management.

Internal auditors are well versed in risk management and control and are capable of helping companies address complex business challenges. Performed by professionals with an in-depth understanding of the business culture, systems and processes, internal audit assists their organizations by independently identifying and examining risks and controls supporting the accuracy of financial reporting. In particular, internal auditors can be instrumental in reporting risks

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threatening the achievement of strategic and operational objectives, as well as helping identify potential fraud involving management or others. When optimized, internal audit can fulfill its most fundamental role – that of supporting management's and boards of directors' ethical pursuit of achieving organizational objectives.

The IIA stands ready to assist Congress and the regulators raise the standards of business conduct and impress on organizations the need to follow sound corporate governance practices, all in the pursuit of cost-effectively enhancing long-term investor confidence.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

(a) Financial Statements

(b) Condensed unconsolidated financial information of Holdings and notes thereto are set forth in Schedule I beginning on Page
F-2 in this Form 10-K and are incorporated herein by reference. Holdings has issued a full and unconditional guarantee of certain outstanding and future debt securities of its wholly-owned subsidiary, Lehman Brothers Inc. Condensed consolidating financial information pursuant to Rule 3-10(c) of Regulation S-X is set forth in Note 8 of the notes to such condensed unconsolidated financial information in Schedule I.

LEHMAN BROTHERS HOLDINGS INC.

Management's Assessment of Internal Control over Financial Reporting

The management of Lehman Brothers Holdings Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system is designed to provide reasonable assurance to the Company's management and Board of Directors regarding the reliability of financial reporting and the preparation of published financial statements in accordance with generally accepted accounting principles. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of November 30, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control–Integrated Framework*. Based on our assessment we believe that, as of November 30, 2007, the Company's internal control over financial reporting is effective based on those criteria.

LEHMAN BROTHERS HOLDINGS INC.

Report of Independent Registered Public Accounting Firm

To The Board of Directors and Stockholders of Lehman Brothers Holdings Inc. 07

We have audited Lehman Brothers Holdings Inc.'s (the "Company") internal control over financial reporting as of November 30, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Assessment of Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of November 30, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of the Company as of November 30, 2007 and 2006, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended November 30, 2007 of the Company and our report dated January 28, 2008 expressed an unqualified opinion thereon.

Ernst + Young LLP

New York, New York
January 28, 2008

LEHMAN BROTHERS HOLDINGS INC.

Report of Independent Registered Public Accounting Firm

To The Board of Directors and Stockholders of Lehman Brothers Holdings Inc.

We have audited the accompanying consolidated statement of financial condition of Lehman Brothers Holdings Inc. (the "Company") as of November 30, 2007 and 2006, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended November 30, 2007. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lehman Brothers Holdings Inc. at November 30, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended November 30, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Lehman Brothers Holdings Inc.'s internal control over financial reporting as of November 30, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 28, 2008 expressed an unqualified opinion thereon.

Ernst + Young LLP

New York, New York
January 28, 2008

Management's report on internal control over financial reporting

Management of JPMorgan Chase & Co. ("JPMorgan Chase" or the "Firm") is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, the Firm's principal executive and principal financial officers, or persons performing similar functions, and effected by JPMorgan Chase's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

JPMorgan Chase's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records, that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Firm's assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Firm are being made only in accordance with authorizations of JPMorgan Chase's management and directors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Firm's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management has completed an assessment of the effectiveness of the Firm's internal control over financial reporting as of December 31, 2011. In making the assessment, management used the framework in "Internal Control — Integrated Framework" promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria.

Based upon the assessment performed, management concluded that as of December 31, 2011, JPMorgan Chase's internal control over financial reporting was effective based upon the COSO criteria. Additionally, based upon management's assessment, the Firm determined that there were no material weaknesses in its internal control over financial reporting as of December 31, 2011.

The effectiveness of the Firm's internal control over financial reporting as of December 31, 2011, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

James Dimon
Chairman and Chief Executive Officer

Douglas L. Braunstein
Executive Vice President and Chief Financial Officer

February 29, 2012

Report of independent registered public accounting firm

pwc

To the Board of Directors and Stockholders of JPMorgan Chase & Co.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in stockholders' equity and comprehensive income and cash flows present fairly, in all material respects, the financial position of JPMorgan Chase & Co. and its subsidiaries (the "Firm") at December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Firm maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Firm's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management's report on internal control over financial reporting." Our responsibility is to express opinions on these financial statements and on the Firm's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

February 29, 2012

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRI

To the Board of Directors and Stockholders of The Bear Stearns Companie:

07

We have audited the consolidated financial statements of The Bear Stearns as of November 30, 2007 and 2006, and for each of the three years in the p Company's internal control over financial reporting as of November 30, 200 January 28, 2008 (such report on the consolidated financial statements exp explanatory paragraph relating to the adoption of Statement of Financial Ac for Certain Hybrid Instruments, an amendment of FASB Statements No. 13 Measurements"); such consolidated financial statements and reports are in and are incorporated herein by reference. Our audits also included the finar Stearns Companies Inc. (Parent Company Only), listed in Item 15. This fina Company's management. Our responsibility is to express an opinion based statement schedule, when considered in relation to the basic consolidated f fairly, in all material respects, the information set forth therein.

Effective December 1, 2006, the Company adopted SFAS No. 155, "Accour of FASB Statements No. 133 and 140" and SFAS No. 157, "Fair Value Mea

/s/ Deloitte & Touche L

New York, New York
January 28, 2008

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Index to Consolidated Financial Statements of MF Global Holdings Ltd.

Consolidated Financial Statements as of and for the years ended March 31, 2011, 2010 and 2009:

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Management's Report on Internal Control over Financial Reporting

Management of MF Global Holdings Ltd. together with its consolidated subsidiaries (the "Company"), is responsible for establishing and maintaining adequate internal control over financial reporting.

The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's consolidated financial statements for external reporting purposes in accordance with accounting principles generally accepted in the United States of America.

The Company's internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an assessment of the effectiveness of the Company's internal control over financial reporting as of March 31, 2011 based on the framework established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management has determined that the Company's internal control over financial reporting as of March 31, 2011 was effective and that there were no material weaknesses in the Company's internal control over financial reporting as of that date.

The Company's internal control over financial reporting as of March 31, 2011 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report included within, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of March 31, 2011.

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PART II
ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
MF Global Holdings Ltd.: //

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, cash flows, changes in equity, and comprehensive income present fairly, in all material respects, the financial position of MF Global Holdings Ltd. and its subsidiaries (the "Company") at March 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2011 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of March 31, 2011, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/S/ PRICEWATERHOUSECOOPERS LLP

New York, New York
May 19, 2011

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Fannie Mae: -07

We have audited the accompanying consolidated balance sheets of Fannie Mae and consolidated entities (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, cash flows, and changes in stockholders' equity for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Fannie Mae and consolidated entities as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 15, 2007 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an adverse opinion on the effectiveness of the Company's internal control over financial reporting because of material weaknesses.

/s/ Deloitte & Touche LLP

Washington, DC
August 15, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Freddie Mac: – 08

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of cash flows, and of stockholders' equity (deficit) present fairly, in all material respects, the financial position of Freddie Mac, a stockholder-owned government-sponsored enterprise, and its subsidiaries (the "Company") at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have also audited in accordance with the standards of the Public Company Accounting Oversight Board (United States) the supplemental consolidated fair value balance sheets of the Company as of December 31, 2008 and 2007. As described in "NOTE 17: FAIR VALUE DISCLOSURES," the supplemental consolidated fair value balance sheets have been prepared by management to present relevant financial information that is not provided by the historical-cost consolidated balance sheets and is not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America. In addition, the supplemental consolidated fair value balance sheets do not purport to present the net realizable, liquidation, or market value of the Company as a whole. Furthermore, amounts ultimately realized by the Company from the disposal of assets or amounts required to settle obligations may vary significantly from the fair values presented. In our opinion, the supplemental consolidated fair value balance sheets referred to above present fairly, in all material respects, the information set forth therein as described in "NOTE 17: FAIR VALUE DISCLOSURES".

The Company has been placed into conservatorship by the Federal Housing Finance Agency ("FHFA"). The U.S. Department of Treasury ("Treasury") has committed financial support to the Company and management continues to conduct business operations pursuant to the delegated authorities from FHFA during conservatorship. The Company is dependent upon the continued support of Treasury and FHFA. These and other related matters are discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements.

As discussed in "NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES" to the consolidated financial statements, the Company changed how it defines, measures and discloses the fair value of assets and liabilities as of January 1, 2008, elected to measure certain financial instruments and other items at fair value that are not required to be measured at fair value, changed its method of accounting for uncertainty in income taxes as of January 1, 2007, elected to measure newly acquired interests in securitized financial assets that contain embedded derivatives at fair value as of January 1, 2007, and changed its method of accounting for defined benefit plans as of December 31, 2006.

/s/ PricewaterhouseCoopers LLP

McLean, Virginia
March 11, 2009