



Q&A: Harvey Pitt on 404

Former SEC Chair Harvey Pitt comments on how to make SOX 404 work for smaller companies without exempting them.

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Perhaps the most controversial topic facing the Securities and Exchange Commission today is the issue of applying the Sarbanes-Oxley Act — and specifically Section 404 of the Act — to smaller companies. The debate has drawn sharp response from several former SEC Chairmen, including William Donaldson, Arthur Levitt, and Richard Breeden. All three have publicly opposed proposals that would exempt smaller companies from rules requiring them to demonstrate effective internal controls over their financial reporting.

In testimony before the Senate Banking Committee earlier this week, SEC Chairman Christopher Cox appeared to walk a middle path in the debate, suggesting that 404 could work for such companies if a more appropriate framework could be developed for smaller companies. That view is not all that different from one recently proposed by another former SEC Chairman, Harvey Pitt, who headed the commission from 2001 to 2003. Now founder and chief executive officer of Kalorama Partners, Pitt talked with CFO.com this week about his perspective on smaller companies and section 404.

The Securities and Exchange Commission's Advisory Committee on Smaller Public Companies has recommended that companies under \$128 million in market cap and \$125 million in revenues be exempt from complying with Section 404 of the Sarbanes-Oxley Act. You have publicly stated that the most significant problem with SOX is its "one-size-fits-all" approach to regulation. Do you agree with the committee's recommendations to scale regulation according to company size?

I agree with the underlying premise, which is that you have to be able to take account of a company's size and other relevant factors in tailoring the rules. The problem is SOX, as it was drafted, doesn't give the SEC that authority. I do not believe, however, that any size company that is public should be completely exempt from every aspect of 404. There are ways to [tailor 404] without effectively eliminating complete coverage with respect to smaller companies — where I think shareholders have the greatest need for a review of internal controls. My hope would be that [the Advisory Committee's exemption recommendation is] not the way the SEC would go.

How do your ideas for applying the Sarbanes-Oxley Act differ from those of the committee?

I've suggested we go toward a 'phase-in.' That would permit the SEC to gather data and make sure that it understands the impact of these new requirements. One of the big concerns about 404, which I think is legitimate, is that it may impose very, very heavy costs on smaller companies that may be disproportionate to any of the benefits they may get.

I've recommended the SEC take, for argument's sake, the first third of public companies that are not now covered and make them subject to, but do not require them to have, a full-blown audit. Instead, we could do something similar to what we do with respect to quarterly financial

reports: Have the auditors review them, but not certify them. That would immediately reduce the costs substantially. That it would prevent people from arguing that the statute's protections had been eroded in any way.

How do your ideas coincide with the committee's recommendations?

Both I and the committee believe there is a need to revisit the effect of Sarbanes-Oxley on companies that are smaller in size, and to get rid of the one-size-fits-all approach.

Where we part company is my concern — because I chaired the SEC when Sarbanes-Oxley was passed — that Congress deliberately sought to prevent the SEC from having the authority make the kind of tailoring changes that the advisory committee is recommending. I do not believe that, under the statute, the SEC would have the authority to preclude whole classes of public companies from complying with provisions of Sarbanes-Oxley, as desirable as that result may ultimately appear. Congress deliberately didn't give the SEC that power. What I worry about is that any effort by the SEC to provide needed relief in this area may well get met with litigation instead of providing people with the kind of relief they really need.

To avoid that, it would be better if we could give the SEC the kind of rule making, adjusting power it needs. [My] proposal could do that because wouldn't require anyone to have changed a single substantive provision of Sarbanes-Oxley. Rather, it would make clear that the SEC has real authority to provide the kind of relief that most people think is needed.

It's possible to do this. I can't tell you that Congress will in fact do it, but I believe they should.

Other former SEC chairmen have also spoken out against the idea of exempting small companies from the internal controls provision. Would exempting small companies adversely affect the market?

I think that the problem with the Advisory Committee's proposals is that it adopts, if you will, an attitude of "let's throw out the baby with the bath water" philosophy. There is a need to have smaller companies be subject to the internal controls review provisions of Sarbanes-Oxley. We just have to find a way to do it that doesn't saddle these companies with economic burdens that are effectively going to destroy innovation and competition in this country. [But exempting them entirely] is too drastic and not necessary. That would potentially weaken public investor protections. My hope is that we can get to where we need to be without having to take that kind of all-or-nothing approach.

At the Senate committee meeting, Cox referred to the Public Company Accounting Oversight Board's Auditing Standard No. 2 and said, "We're going to be aggressively working on implementation with the PCAOB so that we get all the benefits without the needless costs." Do you think the SEC's response will be further pressure on excessive audits?

The problem has stemmed from the language and interpretation the PCAOB has given to Audit Statement No. 2. The accounting profession tried to get clarification, but it was unable to get that. Now, I think everybody realizes that clarification would be exceedingly valuable. I think we now may get to see it. I think Chairman Cox' suggestion of trying to work closely with the PCAOB is exactly the kind of SEC leadership that will produce a workable solution.

A major topic during Cox's Senate testimony this week was the question of whether the U.S. regulatory environment is driving companies overseas. What's your reaction?

I think it is to some extent. [But] the fact is that dynamics in the marketplace are making the issue of where a company has its stock listed largely irrelevant. What's much more relevant is who owns it. What we've seen is that the Sarbanes-Oxley standard is effectively becoming the

de facto world standard and therefore, I'm less concerned that we're going to lose listings. I agree [with Chairman Cox that] we should not have a race to the bottom.

We can apply the principle of convergence in the Sarbanes-Oxley area just the way we're doing with international accounting standards. The SEC has said that companies eventually will not be required to reconcile accounting statements based on IFRS, the international standards, with GAAP, because we've concluded that IFRS is working toward coming up with standards that are quite good.

Lots of companies are becoming subjected to standards [like 404], whether or not their stock is listed in the U.S. I think we'll continue to see that, particularly when you get developments like Nasdaq acquiring up to 15 percent of the London Stock Exchange. It's going to be very, very hard to imagine that the London Stock Exchange is going to have different standards from those that are going to be applied with respect to Nasdaq. I'm optimistic that we are headed toward a global standard for governance and transparency. All things considered, I think that's a good thing.

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