



## MANAGED FUNDS ASSOCIATION

February 26, 2007

**VIA ELECTRONIC MAIL:**

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Office of the Secretary  
Public Company Accounting  
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**Re: SEC File No. S7-24-06;  
PCOAB Rulemaking Docket Matter No. 021**

Ladies and Gentlemen:

Managed Funds Association (“MFA”) appreciates the opportunity to make this submission of comments to the: Securities and Exchange Commission’s (“SEC”) proposed interpretation and rule on “Management’s Report on Internal Control Over Financial Reporting” (“Proposed Management’s Guidance”);<sup>1</sup> and the Public Company Accounting Oversight Board’s (“PCAOB”) proposed auditing statement, “An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,” (“AS5”) and related proposals “Considering and Using the Work of Others” and “Audit Committee Pre-Approval of Services Related to Internal Control” (together, referred to as “Proposed Auditing Guidance” and with Proposed Management’s Guidance, referred to as “Proposed Guidance”) that would supersede Auditing Standard No. 2 (“AS2”).<sup>2</sup>

We commend the SEC and PCAOB’s efforts to provide prospective guidance and rules under Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX 404”) that takes a top-down, risk-based evaluation approach. We believe the Proposed Guidance provides a more pragmatic and cost-effective approach to compliance with SOX 404. Nevertheless, we believe further clarity and flexibility is necessary in the SEC and PCAOB’s final interpretive guidance and rules under SOX 404 (“Final Guidance”). We respectfully request that Final Guidance provide further clarity and flexibility in certain areas, as discussed below, and take the unique position of public commodity pools (“Pools”) into

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<sup>1</sup> Securities Act Release No. 8762 (Dec. 20, 2006), 71 FR 76580.

<sup>2</sup> PCAOB Release No. 2006-007 (Dec. 19, 2006), Docket Matter No. 021.

consideration. We believe such guidance will go a long way in building value for investors without hampering the long-term competitiveness of U.S. capital markets.

## **Introduction**

MFA is the leading U.S.-based membership organization dedicated to serving the needs of professionals who advise, manage and operate commodity pools, as well as hedge funds, and funds of hedge funds. MFA has over 1,300 members, including professionals who manage a significant portion of the estimated \$1.5 trillion invested in these alternative investment vehicles globally. Among the MFA membership are commodity pool operators and commodity trading advisors. As public commodity pools are subject to the requirements of SOX 404, our members have a keen interest in the development of prospective interpretations and rules under SOX 404.

Public commodity pools are regulated by the SEC, Commodity Futures Trading Commission (“CFTC”), National Futures Association (“NFA”), and the National Association of Securities Dealers (“NASD”), and are subject to both substantive and disclosure requirements under various state blue sky laws. MFA respectfully requests that the SEC and PCAOB, in issuing prospective interpretation and rules under SOX 404 consider the unique position that public commodity pools find themselves in as “net asset value”-based entities with multiple regulators and different corporate structures than most public companies.<sup>3</sup> In terms of staffing and resources, many Pools also face similar issues and concerns as smaller public companies.<sup>4</sup> Accordingly, we respectfully request that guidance extended to smaller public companies be extended, as applicable, to Pools.

## **Comments**

We support and appreciate the SEC and PCAOB’s efforts in providing a principles-based approach to compliance with SOX 404. We believe a top-down, risk

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<sup>3</sup> While we believe that commodity pools, like investment companies, should be exempt from Section 404, as set forth in our September 18, 2006 letter to the Commission on the Concept Release Concerning Management’s Reports on Internal Control Over Financial Reporting (File No. S7-11-06), we restrict our comments in this letter to issues raised in the Release. For more information on commodity pools and their regulatory requirements, please see our September 18, 2006 letter.

<sup>4</sup> The Commission’s Advisory Committee on Smaller Public Companies (“Advisory Committee”) raised a number of concerns regarding the ability of smaller public companies to comply cost-effectively with SOX 404 in its Final Report to the Commission. Two of the characteristics the Advisory Committee focused on that create unique differences in how smaller companies achieve effective ICFR that may not be adequately accommodated in current SOX 404 implementation guidance, which we believe are applicable to many Pools include: (1) the limited number of personnel in smaller companies, which constrains the companies’ ability to segregate conflicting duties; and (2) top management’s wider span of control and more direct channels of communication, which increase the risk of management override.

*Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission* (hereinafter “*Final Report of the Advisory Committee*”) (April 23, 2006) at 35-36, available at: <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

based approach is an effective and practical way for management and outside auditors to fulfill their respective obligations regarding reports on internal controls over financial reporting (“ICFR”). Most importantly, we believe that by focusing management and auditors on the matters most important to internal control, the Proposed Guidance promotes a cost-effective method of compliance with SOX 404.

Still, we believe the Proposed Guidance needs to provide further guidance to entities with special characteristics and constraints, such as Pools and smaller public companies, as to how they may comply with SOX 404 within their structural frameworks. Pools and smaller public companies need more guidance as to how, in practice, the Proposed Guidance may be “scalable” and appropriately tailored to their businesses.

## **1. Guidance to Commodity Pools**

Just as the Proposed Guidance takes a more flexible approach and recognizes the constraints of smaller public companies, we believe that a principles-based approach will also provide more flexibility to Pools when it comes to ICFR. Nevertheless, as “net asset value”-based entities, Pools have some inherent differences from public companies, which can make compliance with the Proposed Guidance disproportionately more difficult. We hope the SEC and PCAOB in promulgating, as well as implementing, rules and guidance under SOX 404, will take into consideration the unique differences, characteristics, and constraints of Pools. We are concerned that without this flexibility, the overly burdensome expense of SOX 404 compliance, will weaken the competitive stance of Pools’ against alternative investment vehicles not subject to SOX 404, and diminish their overall contribution to the U.S. capital markets.

### *a) Pool Characteristics*

The internal controls employed by Pools and their operators in connection with Pool financial reporting are rigorous, effective and wholly adequate to the business operations of Pools.<sup>5</sup> At the same time, they do not conform to the governance structure contemplated by SOX 404 and, more specifically, the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Framework), which provides the fundamental model for SOX 404

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<sup>5</sup> Pools trade highly liquid assets in a world of daily, marked-to-market settlements, the bulk of their assets are held at banks, futures commission merchants (“FCM”s) and securities dealers, i.e., entities subject to regulatory oversight, and their operations are fully summarized in daily brokerage and account statements. Pool operators tend to rely to a large degree on “tone at the top” and other high-level monitoring approaches to control, along with some segregation by function giving consideration to the size of the Pool operator’s staff. Pool operators generally hire external administrators to perform functions, such as accounting.

Further, many Pools have SAS 70 exams conducted and provide such reports to their customers to demonstrate that the Pool has undergone an in-depth audit of their control activities by independent auditors. *See supra* note 12 and accompanying text.

compliance. Pools have no directors, officers or employees, let alone independent directors. In this respect, Pools differ from mutual funds and smaller public companies, which have boards and directors/officers. Pool operators, many of which are smaller privately held corporations or limited liability companies, serving as the Pool's general partner or equivalent, are generally managed by their ownership without independent directors. The SEC has already excluded asset-backed issuers from the rules implementing Section 404 in part due to the governance structures of those entities.<sup>6</sup>

In addition, the Pools' net asset value structure makes the burden of compliance more onerous than in the case of other public companies. If an operating company were to pay \$1 million to achieve SOX 404 compliance, it is unclear how that expenditure will affect the value of such company's stock.<sup>7</sup> In the case of a Pool, that \$1 million expenditure directly impacts the bottom line, reducing the net asset value of investors' holdings dollar for dollar.<sup>8</sup> We would also like to point out that while accurate Pool financial reporting is relevant to Pool investors for a variety of reasons, the integrity of Pool financial reporting controls is not relevant to any "market." Pools generally issue securities that do not trade in any market<sup>9</sup> and which, accordingly, cannot be the subject of manipulation. Accordingly, and not surprisingly, Pool investors and prospective investors do not typically analyze a Pool's financial statements to assess the appropriateness of the Pool's per unit value or the future prospects of the Pool. Pool investors are much more interested in monthly and annual rates of return, which the CFTC requires Pool operators to provide, together with a statement of income (loss) and a statement of changes in net asset value for the current period, to the investor on a monthly basis.<sup>10</sup>

*b. Guidance Considering Pools*

Internal controls are, of course, crucial regulatory compliance tools to the extent they are properly applied to an issuer. However, "[t]he primary objective of internal control over financial reporting requirements should be the prevention of materially

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<sup>6</sup> See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, 68 FR 36,648 (June 18, 2003).

<sup>7</sup> See CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update, at 1.

<sup>8</sup> Section 2(b) of the Securities Act of 1933 mandates that whenever the SEC engages in rulemaking, it is required to consider whether the action will promote efficiency, competition and capital formation. See Peter J. Wallison, *Buried Treasure: A Court Rediscovered A Congressional Mandate the SEC Has Ignored*, AEI Online (Oct. 2005).

<sup>9</sup> Exchange traded Pools are index funds, the components of which are futures contracts the "trading" of which is completely driven by published rules. These ETFs report both the net asset value of the indices and the net asset value of the funds several times each minute.

<sup>10</sup> 17 CFR 4.22(a).

inaccurate financial statements; companies operate differently, depending on size, and internal control rules should reflect this fact; and the benefits of any regulatory burden—Section 404-related or otherwise—should outweigh the costs.”<sup>11</sup> We believe the simplicity of the Pools’ operations as “net asset value”-based entities engaged solely in trading activities, should likewise, translate into a more simplified assessment of ICFR.

The SEC and PCAOB have indicated that rules and guidance under SOX 404 are meant to be scalable. We believe, however, that the draft regulations do not go far enough in providing practical and scalable guidance for many Pools and smaller public companies.

*(i) Proposed Auditing Standard: Considering and Using the Work of Others*

The PCAOB’s “Considering and Using the Work of Others” proposed auditing standard allows auditors to rely on the work of others, such as internal audits conducted by an independent audit committee or personnel. However, given their size, management is often more intimately involved in the day-to-day operations at many Pools and smaller public companies. We understand that in instances where management reports directly to those who sign the issuer’s financial attestation, as is the case at many Pools and smaller public companies, the less outside auditors are able to rely on management’s work product. For many Pools and smaller public companies, this translates directly into greater audit expenses since outside auditors will have to spend more time performing an independent review. The end result is that many Pools and smaller public companies would continue to be burdened with relatively greater audit expenses than larger public companies.

In addition, many Pools voluntarily have an annual “Statement of Auditing Standards No. 70” (“SAS 70”) examination performed and provide the accompanying reports to customers/investors. Completing a SAS 70 exam shows that an entity has had an in-depth audit of its control activities conducted by an independent accounting and auditing firm.<sup>12</sup> In many instances, testing that is performed for a SAS 70 exam will be duplicative of testing performed to satisfy SOX 404 requirements. We respectfully request the PCAOB in its “Considering and Using the Work of Others” auditing standard, allow management and external auditors to consider SAS 70 reports in evaluating ICFR. We believe this would eliminate unnecessary, duplicative procedures and reduce costs, while maintaining the integrity of the process as SAS 70 exams are conducted by independent auditors.

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<sup>11</sup> *Final Report of the Advisory Committee, supra* note 4 at 22.

<sup>12</sup> SAS 70 reports are provided in a uniform reporting format. As such, they enable investors to compare reports across different investment vehicles, many of which are not subject to SOX 404. Some Pool investors specifically request for SAS 70 reports.

*(ii) Proposed rule 3525: Audit Committee Pre-approval of Services Related to Internal Control*

We believe the PCAOB's "Audit Committee Pre-approval of Services Related to Internal Control" proposed independence rule is more appropriate than the direction regarding independence and internal control-related services provided in AS2. However, as Pools are not required and do not find it necessary as a "net asset value"-based entity to have an audit committee, many do not. In providing scalable guidance, we hope the PCAOB will consider the structural characteristics of Pools and provide applicable guidance.

*(iii) Guidance through Illustrative Examples*

We believe that one method, by which the SEC and PCAOB may provide further guidance while remaining principles-based in approach, is through the use of illustrative examples of how guidance under SOX 404 should be implemented. Illustrative examples would provide public companies with a clearer sense of what constitutes an acceptable level of internal controls and compliance with SOX 404. Further, we believe that illustrative examples would be especially helpful in providing Pools and smaller public companies, which have different characteristics and constraints from larger public companies, with a better understanding of how in practice the Proposed Guidance may be "scalable." Illustrative examples would also provide Pools and smaller public companies practical guidance and assurance that it's possible for them to comply with SOX 404 without radically changing their operations or business objectives.

The Proposed Management's Guidance indicates that management must maintain "reasonable support" for its assessment, but provides little guidance on the nature and extent of documentation to be maintained. An illustrative example might provide that documentation may be maintained in either hardcopy or electronic media, and that the extent of the documentation may be satisfied by narratives, flowcharts, and/or forms, among other methods. We believe illustrative examples would also be helpful in showing when a control weakness may constitute a "material weakness."

## **2. Duplicative Regulation by SEC and PCAOB**

We share the view expressed by other public issuers that SOX 404(b) does not require outside auditors to perform an audit of internal control. From our experience, the external audit of internal control promulgated by the PCAOB in AS2, greatly increased compliance costs, is duplicative of, if not overshadowing of, management's role in assessing internal controls, and is not cost-efficient. For example, external auditors in conducting full-blown audits of internal control have performed limited control testing despite the fact that many balance sheet items may be cross-checked and validated against externally generated third party statements produced by FCMs and custodians. We applaud the SEC and PCAOB's efforts for providing more scalable, risk-based, and cost-efficient guidance.

However, we are concerned that the Proposed Guidance provides different, and not necessarily consistent, guidance on the issue of assessing ICFR. We believe the Proposed Management's Guidance provides more flexibility, while the Proposed Auditing Guidance is much more prescriptive. Some areas where the Proposed Guidance differs, for example, include discussion of: control environment evaluation, identifying significant accounts, and strong indicators of material weakness, as discussed in the Institute of Management Accountants February 13, 2007 letter to the SEC and PCAOB.<sup>13</sup>

*a. Proposed Management's Guidance*

While we appreciate the flexibility provided in the SEC's Proposed Management's Guidance, we are concerned that in practice the SEC guidance will be superseded by the PCAOB's more prescriptive Proposed Auditing Guidance. Since management relies on its outside auditor to approve its assessment of internal controls, we fear that the PCAOB's Proposed Auditing Guidance will become the de facto standard for management.

We believe the SEC should maintain its top-down, risk-based approach for ICFR, but provide management with greater confidence and certainty as to when, and how they may, fulfill such obligation. We believe that under SOX 404, management, rather than the auditor, is responsible for determining the appropriate controls, evaluation methods, procedures, and documentation of ICFR. Management is also in the best position to tailor the compliance procedures to fit the unique characteristics of its company. However, without more information on the minimum standard of internal control compliance, management will continue to live in uncertainty as to whether its internal controls will be overridden and redesigned by outside auditors. Further guidance will not only help improve management's efficiency in conducting an internal assessment, but will also provide management together with outside auditors, with a better understanding of what constitutes an acceptable internal review. Without such guidance, we are concerned the result will be that Proposed Auditing Guidance, like AS2, will continue to overshadow management's ICFR.

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<sup>13</sup> Institute of Management Accountants, Letter regarding SEC File No. S7-24-06 and PCAOB Rulemaking Docket No. 021 (Feb. 13, 2007), at 2, *available at*: <http://www.sec.gov/comments/s7-24-06/lddevonish-mills5470.pdf>. The letter provides:

**Control Environment Evaluation** – AS5 indicates that the auditor should assess the company's control environment and lists 5 specific areas for attestation. The SEC guide makes passing reference to the concept but does not provide specific evaluation criteria or any information on what would constitute a failing grade on control environment.

**Identifying Significant Accounts** – AS5 lists 9 specific factors that should be used to identify significant accounts. SEC guidance has no parallel guidance for management.

**Strong Indicators of Material Weakness** – AS5 lists almost 3 pages of specific factors that are relevant to determining if a material weakness is present. The SEC guidance starting on page 41 provides similar but different criteria to be used by management.

*b. Proposed Auditing Guidance*

We believe the Proposed Auditing Guidance represents a significant improvement from AS2 in terms of its responsiveness to the requirements of SOX 404, scalability, and cost-benefit. We believe removing the requirement to evaluate management's process and allowing auditors to consider and use the work of others, as directed by the Proposed Auditing Guidance, is key to reducing duplicative and redundant assessments of ICFR.

Nevertheless, we believe the Proposed Auditing Guidance does not go far enough in optimizing the cost/benefit equation, and could further reduce duplicative control evaluations. AS5 should focus on audit considerations and direct auditors to use the same SEC interpretive guidance used by management with respect to understanding how to complete an assessment of ICFR.

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We believe the Proposed Guidance is a vast improvement from the status quo, but believe that continued and increased coordination between the SEC and PCAOB would further optimize the cost-benefit of SOX 404. We encourage the SEC and PCAOB to continue to work together in providing mutually reinforcing, cost-efficient guidance under SOX 404 that maximizes investor benefit while eliminating duplicative and redundant regulation.

**3. Safeness of the SEC's Safe Harbor**

We are in favor of the concept of a safe harbor under proposed Exchange Act Rule 13a-15(c) that would provide management that conducts an evaluation in accordance with Proposed Management's Guidance, certainty that it has satisfied its obligation to conduct an evaluation for purposes of Rule 13a-15(c). Nevertheless, for all of the reasons previously stated, we believe that the Proposed Guidance currently does not provide enough clarity and guidance for Pools to assess with an appropriate level of certainty that they have conducted an evaluation in accordance with the interpretive guidance.

We believe further guidance from the SEC and PCAOB, as discussed above, such as through illustrative examples, would greatly enhance SOX 404 compliance, increase investor value, improve cost-efficiency, as well as construct a "safer" safe harbor under Rule 13a-15(c).

**4. Extension of Compliance Date for Non-Accelerated Filers**

We respectfully request that the SEC delay implementation of the compliance date for management's report of internal controls and the auditor's attestation requirement for another year. Provided that Final Guidance is issued in May or June of 2007 at the earliest, issuers will have little time to comprehend how the Final Guidance



translates into practice, let alone implement the necessary evaluation process, including testing and documentation, and/or remediation of any identified weaknesses. Without an extension, management of many Pools and smaller public companies will struggle to implement adequate internal controls while juggling their day-to-day responsibilities.

We believe an extension in the compliance date for management's report for ICFR and the auditor attestation requirement would provide non-accelerated filers with the necessary time to adequately focus on the internal assessment process; and to discuss with their auditors PCAOB's new auditing standards and implementation guidance. We believe this will translate into added-value and cost savings for investors.

### **Conclusion**

MFA appreciates the opportunity to provide its views on the Proposed Guidance that the SEC and PCAOB have promulgated, and respectfully requests for the reasons stated herein that Final Guidance take into consideration the unique characteristics of Pools and provides more scalable guidance. We would welcome an opportunity to meet with Commissioners and Staff if that would provide assistance in your deliberations on these issues.

Respectfully submitted,



John G. Gaine  
President

Cc: The Hon. Christopher Cox, Chairman, SEC  
The Hon. Paul S. Atkins, Commissioner, SEC  
The Hon. Roel C. Campos, Commissioner, SEC  
The Hon. Annette L. Nazareth, Commissioner, SEC  
The Hon. Kathleen L. Casey, Commissioner, SEC  
John White, Director, Division of Corporation Finance, SEC  
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The Hon. Mark W. Olson, Chairman, PCAOB  
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The Hon. Bill Gradison, Board Member, PCAOB  
The Hon. Charles D. Niemeier, Board Member, PCAOB