Council of Institutional Investors
The Voice of Corporate Governance

July 31, 2012

The Honorable Scott Garrett
Chairman
House Capital Markets Subcommittee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Capital Markets Subcommittee
B371A Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

We are writing in opposition to H.R. 6161, the "Fostering Innovation Act" (Bill). The Bill would revise the definition of accelerated filer, as defined in SEC Rule 12b-2 (17 C.F.R. 240.12b-2) by exempting those public companies that have a market value below $250 million, and exempting companies with a market value between $250 million and $700 million if annual revenues are under $100 million. This would more than triple the market capitalization threshold <u>and</u> it introduces a revenue component to the definition of accelerated filer.

The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of pension funds and other employee benefit funds, foundations and endowments with combined assets that exceed $3 trillion, and a leading voice for good corporate governance and strong shareowner rights.

The CAQ is a public policy organization 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 more than 600 audit firm members, most of which are public company audit firms registered with the Public Company Accounting Oversight Board (PCAOB). Our member firms are committed to fulfilling the public interest role that auditors play in our capital markets.

We believe the Bill, which would likely affect hundreds of issuers, would substantially impact the quality and timing of financial disclosures by sizable public companies to the detriment of investors and our capital markets more generally.

One unfortunate consequence of eliminating this large group of issuers from the definition of accelerated filers is that their annual and quarterly reports would be issued on a delayed schedule. This would have an undesirable impact on access to information about the financial condition and results of operations of these companies, which their investors and the markets have come to expect in a timely manner. We urge you to consult with the SEC on this and other potential ramifications of the Bill under the broader securities laws.

Another significant negative effect of the Bill would be to permanently exempt these companies from Section 404(b) of the Sarbanes Oxley Act. Section 404(b) provides investors with important assurance by the independent auditor performing the financial statement audit regarding a CEO and CFO's representations about the effectiveness of their company's internal control over financial reporting

(ICFR). This assurance is an important driver of confidence in the integrity of financial reporting and in the fairness of our capital markets.

It is difficult to see how delaying the issuance of annual and quarterly reports by this group of companies or exempting them from compliance with Section 404(b) would have a positive effect on innovation. Moreover, it is not clear that companies would realize significant cost savings from an exemption from Section 404(b) because the ICFR audit is now fully integrated with the financial statement audit, and the quality of the control environment is an explicit factor auditors must consider in scoping the financial statement audit under the PCAOB's risk assessment standards (See e.g., PCAOB Auditing Standard (AS) No. 8, *Audit Risk*, and AS No. 12, *Identifying and Assessing Risks of Material Misstatement*). In any event, if there were to be savings, it is not clear how companies would allocate those funds across their operations, including compensation.

Conversely, there are a number of reasons why the application of Section 404(b) should be retained in current form.

To be succinct, we refer to the "Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million" issued by the SEC in 2011.[1] The study focused on the impact of Section 404(b) on the population of issuers targeted by the Bill in terms of their: size in terms of assets and revenues; industries; geographic location; audit fees and scalability; restatement rates; and reported material weaknesses in ICFR. A significant portion of the issuers studied were in the medical equipment, pharmaceutical product, banking and insurance industries. Notably, the study found that issuers falling into this group did <u>not</u> show characteristics that suggested sufficient reasons for differentiating them from accelerated filers taken as a whole.

The study summarized the SEC staff's own findings, and academic and other research indicating that the cost of compliance with Section 404(b), including both total costs and audit fees declined by approximately 30 percent after the PCAOB adopted AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the SEC issued management guidance on Section 404(a) in 2007.

Of keen importance to investors and markets, the SEC study found that companies not subject to 404(b) tend to have <u>significantly more</u> material weaknesses in their internal controls and found that auditor involvement in ICFR is positively correlated with more accurate and reliable disclosure of all internal control deficiencies that conveys relevant information to investors about the company and how it is managed. The study also found that companies that would be impacted by the Bill generally had a lower rate of restatements than those that are not subject to Section 404(b), and posited that Section 404(b) may contribute to valuable investor protections. Moreover, the SEC did not identify conclusive evidence linking the enactment of Section 404(b) to decisions by these companies to exit the reporting requirements of the SEC, including ICFR reporting.

The SEC study concluded that the continued application of Section 404(b) should be maintained for this group of issuers and <u>no</u> additional exemptions should be granted.

Two years ago, a permanent exemption from Section 404(b) was granted to public companies with less than $75 million in market capitalization under the Dodd Frank Act. And, just a few months ago,

[1] http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

Congress granted a five year exemption from Section 404(b) and other securities laws requirements for "emerging growth companies" as part of the Jumpstart Our Businesses (JOBS) Act. Unlike the companies that would be covered by the Bill and which have been complying with Section 404(b) since 2004, the companies exempted from Section 404(b) by the Dodd Frank Act and the JOBS Act have never had to comply with the section. Therefore, the Bill represents a further unnecessary and significant reduction in current investor protections.

Accordingly, the Council for Institutional Investors and the Center for Audit Quality strongly urge you to oppose the Bill and, in the interest of investors who are so important to our capital markets, to oppose any further efforts to further weaken Section 404(b).

Sincerely,

Cindy Fornelli
Executive Director
Center for Audit Quality

Jeff Mahoney
General Counsel
Council of Institutional Investors

cc: All Members of the House Capital Markets Subcommittee
The Honorable Spencer Bachus, Chairman, House Financial Services Committee
The Honorable Barney Frank, Ranking Member, House Financial Services Committee