

Via E-Mail

July 25, 2019

Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090

*Re: File Number S7-06-19*

Dear Madam Secretary:

The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, foundations, and endowments with combined assets under management of approximately \$4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than \$35 trillion in assets under management.<sup>1</sup>

CII appreciates the opportunity to share our views and provide input on the proposed amendments included in the Securities and Exchange Commission's (Commission or SEC) Proposed Rule, Amendments to the Accelerated Filer and Large Accelerated Filer Definitions (Proposal or Proposed Rule).<sup>2</sup> As a result of the Proposal, certain low-revenue issuers<sup>3</sup> would not be required to comply with Section 404(b) of the Sarbanes-Oxley Act of 2012 (SOX)<sup>4</sup> and have their assessment of the effectiveness of internal control over financial reporting (ICFR) attested to, and reported on, by an independent auditor.<sup>5</sup> CII supports the ICFR auditor attestation requirement and, therefore, opposes the Proposed Rule.

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<sup>1</sup> For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at <http://www.cii.org>.

<sup>2</sup> Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, Exchange Act No. 85,814, 84 Fed. Reg. 24,876 (proposed rule May 29, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-05-29/pdf/2019-09932.pdf>.

<sup>3</sup> *Id.* (a low-revenue issuer is defined under the proposed amendments as a "smaller reporting company [with] . . . annual revenues of less than \$100 million in the most recent fiscal year for which audited financial statements are available").

<sup>4</sup> Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, § 404(b) (July 30, 2002), *available at* <https://www.congress.gov/bill/107th-congress/house-bill/3763/text> ("(b) Internal Control Evaluation and Reporting.-With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.").

<sup>5</sup> 84 Fed. Reg. at 24,876.

## ICFR Auditor Attestation Requirement Benefits Investors and Capital Markets

CII believes the ICFR auditor attestation requirement provides investors with reasonable assurance from the independent auditor that the company maintained effective internal control over financial reporting. That assurance is an important driver of confidence in the integrity of financial statements and in the fairness of our capital markets.

We believe the Proposed Rule amendments allowing low-revenue issuers to avoid the ICFR auditor attestation requirement could significantly affect the ability of investors to make informed investment decisions because it would substantially impact the quality of financial reporting by those issuers.

### Investors in Low-Revenue Issuers Benefit More from ICFR Auditor Attestation Requirement

CII believes that investors in low-revenue issuers benefit more from the ICFR auditor attestation requirement than investors in some other issuers. Our view is supported by academic research indicating that the likelihood of fraud is most pronounced in high-growth companies with large price-to-revenue ratios – precisely those companies that the Commission has proposed to exempt from the ICFR auditor attestation requirement.<sup>6</sup>

Our view is also supported by the research performed by SEC Commissioner Robert J. Jackson, Jr. in response to the Proposal.<sup>7</sup> That research examines how investors react to news of an internal control failure at different groups of issuers.<sup>8</sup> The data indicates that rolling back Section 404(b) of SOX for low-revenue issuers is exactly the group of issuers where investors care about the benefits of ICFR auditor attestation the most.<sup>9</sup>

### Economic Analysis is Incomplete

CII believes the SEC's economic analysis of the Proposed Rule is, at best, incomplete. In our opinion, the analysis does not provide an adequate basis for the Proposal.

We strongly support the view put forward in a comment letter to the SEC earlier this month.<sup>10</sup> In that letter, Professors Mary Barth (Stanford University), Wayne Landsman (University of North Carolina), Joseph Schroeder (Indiana University) and Daniel Taylor (Wharton/University of Pennsylvania) present three reasons why the SEC's analysis is incomplete:

1. The analysis quantifies the cost of ICFR audits, but does not attempt to quantify the benefits of the audits

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<sup>6</sup> Letter from Mary Barth, Graduate School of Business, Stanford University et al. to Securities and Exchange Commission (July 11, 2019), <https://www.sec.gov/comments/s7-06-19/s70619-5802113-187069.pdf>.

<sup>7</sup> Commissioner Robert J. Jackson Jr., Public Statement, Statement on Proposed Amendments to Sarbanes Oxley 404(b) Accelerated Filer Definition (May 9, 2019), <https://www.sec.gov/news/public-statement/jackson-statement-proposed-amendments-accelerated-filer-definition>.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Letter from Mary Barth.

2. The analysis focuses on the rate of restatements among affected companies and does not consider the magnitude of the restatements
3. The analysis does not consider the historical rate of fraud or SEC Accounting and Enforcement Actions within the set of affected companies.<sup>11</sup>

Professors Barth, Landsman, Schroeder and Taylor note that the Commission’s estimate of cost savings at the companies forgoing internal control audits “amounts to less than 0.1% of the average affected company’s equity market value,” and should be “weighed against the potentially large social costs created by weaker internal controls and elevated levels of accounting restatements.”<sup>12</sup> Similarly, Commissioner Jackson concluded from his research that the Proposal “has no apparent basis in evidence.”<sup>13</sup>

The remainder of this letter contains our detailed responses to select questions contained in the Proposal that are directed at, and of interest to, many CII members. Following each of the three questions (in bold), we provide our responses.

**SEC QUESTION: With respect to the ICFR auditor attestation requirement, is the issuer’s level of revenues relevant to the complexity of its financial systems and controls and the nature of its ICFR? If so, how does that complexity affect the benefits and costs of ICFR auditor attestation? How do the benefits and costs of the ICFR auditor attestation requirement vary with the complexity of an issuer’s financial reporting? Are the financial statements of low-revenue issuers less susceptible to the risk of material misstatements or control deficiencies such that the effect of an ICFR auditor attestation may be less significant than for other types of issuers? Would the proposed approach allow low-revenue issuers to benefit from cost savings without significantly affecting the ability of investors to make informed investment decisions based on the financial reporting of those issuers?**<sup>14</sup>

**CII RESPONSE:** We believe the proposed approach allowing low-revenue issuers to avoid the ICFR auditor attestation requirement of Section 404(b) of SOX could significantly affect the ability of investors to make informed investment decisions based on the financial reporting of those issuers. As CII stated in a joint 2016 letter with the Center for Audit Quality, eroding the ICFR auditor attestation requirement is a mistake because by doing so the Commission would “substantially impact the quality of financial reporting by public companies to the detriment of investors and our capital markets more generally.”<sup>15</sup>

Our view is supported by academic research. For example, in a 2016 survey of 344 buy-side analysts from 181 investment companies, 60% responded that ICFR weaknesses are definitively

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<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> Commissioner Robert J. Jackson Jr., Public Statement.

<sup>14</sup> 84 Fed. Reg. at 24,885.

<sup>15</sup> Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, and Cynthia M. Fornelli, Center for Audit Quality, to U.S. Securities and Exchange Commission 2 (Aug. 30, 2016), <https://www.sec.gov/comments/s7-12-16/s71216-17.pdf>.

a red flag of management to misrepresent financial results.<sup>16</sup> The survey also found that the existence of a material ICFR weakness was the most common red flag for misrepresentation followed by weak corporate governance.<sup>17</sup> The survey results are not surprising, since “the academic literature consistently finds that internal control weaknesses are associated with lower quality financial reporting (e.g., Ashbaugh-Skaife, Collins, Lafond, and Kinney 2011).”<sup>18</sup>

Moreover, investors of low-revenue issuers are likely to be more, rather than less, impacted than investors of many other public companies because the “academic research shows theoretically and empirically that the likelihood of fraud is most pronounced in high-growth companies with large [price-to-revenue] ratios—precisely those companies that the Commission proposes to exempt from internal control audits.”<sup>19</sup>

SEC Commissioner Jackson’s research, mentioned above, examined how investors react to news of an internal control failure at different groups of issuers.<sup>20</sup> The resulting data “show[s] [that the Proposal Rule] . . . roll[s] back 404(b) for exactly the group of companies where investors care about the benefits of auditor attestation *most*.”<sup>21</sup>

A similar conclusion was reached by Professor John Hassell, Professor of Accounting, Indiana University, who commented in response to the Proposal that:

Investors in the smaller companies are those that benefit significantly from the assurance provided by an annual review of internal controls by an outside auditor. The companies most likely to have relief are smaller biotech companies. Investors need assurance that effective internal controls are in place at these types of companies.<sup>22</sup>

We are disappointed that the Proposal fails to properly consider that many issuers have concluded that complying with Section 404(b) creates value for their companies.<sup>23</sup> For example, a recent survey of public companies found that 57% responded that one of the primary benefits of Section 404(b) was “improved internal control over financial reporting (ICFR) structure.”<sup>24</sup>

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<sup>16</sup> See Lawrence Brown et al., *The Activities of Buy-side Analysts and Determinants of their Stock Recommendations*, 62 J. Acct. & Econ. 139-156 (2016), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2808634](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2808634).

<sup>17</sup> *Id.*

<sup>18</sup> Letter from Mary Barth.

<sup>19</sup> *Id.*

<sup>20</sup> Commissioner Robert J. Jackson Jr., Public Statement.

<sup>21</sup> *Id.*

<sup>22</sup> Letter from John Hassell, Professor of Accounting, Indiana University, File No. S7-06-19 (May 19, 2019), <https://www.sec.gov/comments/s7-06-19/s70619-5541219-185289.htm>.

<sup>23</sup> See, e.g., *Benchmarking SOX Costs, Hours and Controls*, Protiviti 30 (June 24, 2019), [https://www.protiviti.com/sites/default/files/united\\_states/insights/2019\\_sarbanes-oxley\\_compliance\\_survey-protiviti.pdf](https://www.protiviti.com/sites/default/files/united_states/insights/2019_sarbanes-oxley_compliance_survey-protiviti.pdf).

<sup>24</sup> *Id.*

We also are disappointed that the Proposal appears to reverse the conclusion and recommendations of a study of Section 404(b) by the SEC's Staff of the Office of the Chief Accountant (OCA Study).<sup>25</sup> That thoughtful 118-page study, mandated by SOX and subject to public comment, concluded:

The Staff believes that the existing investor protections [from] . . . the auditor attestation provisions of Section 404(b) should be maintained (i.e., no new exemptions). There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Staff did not find any specific evidence that such potential savings would justify the loss of investor protections and benefits to issuers . . . ."<sup>26</sup>

We believe the OCA Study conclusion should not be replaced with the Proposal's analysis. The latter, as the Barth/Landsman/Schroeder/Taylor letter cited above persuasively argues, is, at best, incomplete, with no attempt to quantify benefits (only costs), no consideration for magnitude of restatements, and no analysis of enforcement actions directed toward the set of affected companies.

It is not at all clear to us that costs from expanding the exemption to internal control requirements cannot be quantified. A 2017 study estimates that from 2007 through 2014 for a sample of firms exempt from 404(b), while "benefits" of the exemption totaled \$388 million from audit fee savings, estimated "costs" totaled \$719 million in foregone future earnings due to failure to remediate defective internal controls, and \$935 million in cost to new shareholders due to elevated market prices when they bought shares, when internal control problems were unknown.<sup>27</sup> We admit that there would be additional, hard-to-estimate costs from decline over time in investor confidence in markets with regard to exempt companies. But the SEC should attempt to measure costs to investors of a proposed change, and we believe that at least some of the cost can be estimated with appropriate methodologies.

Finally, we are also disappointed that the Proposal includes language suggesting that allowing low-revenue issuers to avoid the ICFR auditor attestation could address the decline "in the number of issuers listed on major exchanges."<sup>28</sup> We do not believe the ICFR auditor attestation requirement is an "impediment to capital formation."<sup>29</sup>

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<sup>25</sup> Staff of the Office of the Chief Accountant of the U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million (Apr. 2011), <https://www.sec.gov/news/studies/2011/404bfloat-study.pdf>.

<sup>26</sup> *Id.* at 112.

<sup>27</sup> Weili Ge, Allison Koester and Sarah McVay, Benefits and Costs of Sarbanes-Oxley Section 404(b) Exemption: Evidence from Small Firms' Internal Control Disclosures, 63 J. Acct. & Econ. 358-384 (Apr.-May 2017), available at <https://www.sciencedirect.com/science/article/pii/S0165410117300113>.

<sup>28</sup> 84 Fed. Reg. at 24,880; *but see id.* at 24,903 ("However, research investigating the link between SOX and companies exiting or choosing not to enter public markets has been inconclusive.").

<sup>29</sup> Letter from Jeff Mahoney, CPA, General Counsel, Council of Institutional Investors et al. to The Honorable Jeb Hensarling, Chairman, House Financial Services Committee et al. 2 (May 1, 2017), <https://www.thecaq.org/caq-cii-and-cfa-institute-submit-joint-letter-financial-choice-act/>.

We note that the OCA Study analyzed the linkage between Section 404(b) and the number of issuers and concluded that “while the research regarding the reasons for listing decisions is inconclusive, the evidence does not suggest that granting an exemption to issuers . . . would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States.”<sup>30</sup> The OCA Study conclusion reflects the fact that the declining trend in the number of issuers was firmly in place prior to the adoption of SOX.<sup>31</sup> Moreover, as the Commission is well aware, recent research has consistently found that the primary factors in the decline in the number of public companies is the corresponding growth in the private markets<sup>32</sup> and the related increase in mergers and acquisitions.<sup>33</sup>

**SEC QUESTION: What are the costs and benefits of the proposed amendments for investors and issuers? For example, what are the direct costs associated with an ICFR auditor attestation requirement, such as audit fees, as well as indirect costs, such as those related to managerial time and attention, for the group of SRCs [small reporting companies] that would be exempted from that requirement under the proposed approach? What would be the effects on potential direct and indirect benefits associated with the ICFR auditor attestation requirement for the group of SRCs that would be exempted from that requirement under the proposed approach? Is it possible to relate the benefits to restatement rates or other measures of financial reporting quality for this group? What would be the effect on these issuers’ cost of capital and investor confidence?<sup>34</sup>**

**CII RESPONSE:** We believe that the potential costs associated with the ICFR auditor attestation requirement for the group of low-revenue issuers that would be exempted under the

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<sup>30</sup> Staff of the Office of the Chief Accountant of the U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million at 112.

<sup>31</sup> See, e.g., Michael J. Mauboussin et al., Credit Suisse, The Incredible Shrinking Universe of Stocks, The Causes and Consequences of Fewer U.S. Equities 5 (Mar. 22, 2017), [http://www.cmgwealth.com/wp-content/uploads/2017/03/document\\_1072753661.pdf](http://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf) (“the trend toward delisting was firmly in place prior to the implementation of Sarbanes-Oxley”).

<sup>32</sup> See, e.g., EY, Looking Behind the Declining Number of Public Companies, An Analysis of Trends in US Capital Markets 8 (May 2017), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf> (“The private capital market has grown aggressively recently, allowing emerging companies to access more capital without going public.”).

<sup>33</sup> See, e.g., Craig Doidge et al., The U.S. Listing Gap, 123 J. Fin. Econ. 464, 465-66 (Mar. 2017), available at <https://www.sciencedirect.com/science/article/pii/S0304405X1630232X> (“we . . . find . . . the U.S. had an unusually high number of merger delists after 1996”); see generally, Jeffrey Gangemi, M&As are Up, IPO’s are Down. What is the Story?, Cornell, SC Johnson C. of Bus. (Feb. 28, 2019), <https://business.cornell.edu/hub/2019/02/28/mas-are-up-ipos-are-down-whats-the-story/> (discussing and providing data on the impact of mergers and acquisitions and the growth of private capital on the decline on the number of publicly listed companies in the United States). Ironically, the Securities and Exchange Commission is currently soliciting comments on a proposed rule that would reduce disclosures relating to mergers and acquisitions and describes one of the potential benefits of the proposal as “encourag[ing] registrants to engage in more . . . mergers and acquisitions than they otherwise would engage in without the proposed amendments.” Amendments to Financial Disclosures About Acquired and Disposed Businesses, Securities Act Release No. 10,635, Exchange Act Release No. 85,765, Investment Company Act Release No. 33,465, 84 Fed. Reg. 24,600, 24,631 (proposed rule May 28, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-05-28/pdf/2019-09472.pdf>.

<sup>34</sup> 84 Fed. Reg. at 24,918.

Proposal includes the cost of the loss of investor confidence in public company financial reporting.<sup>35</sup> As we have previously explained to the Commission:

Section 404(b) continues to be significant as it provides investors with reasonable assurance from the independent auditor that the company maintained effective internal control over financial reporting. This assurance is an important driver of confidence in the integrity of financial statements and in the fairness of our capital markets.<sup>36</sup>

We note that the OCA Study reviewed the research on whether Section 404(b) makes a difference in users' confidence in financial statements (current and future), as well as audit reports on them.<sup>37</sup> That review found, among other evidence, that "[e]quity analysts who were given Section 404(b) reports with entity-level weaknesses versus those given reports with account-specific weaknesses or no material weaknesses had lower confidence in internal control strength, the most recent year's audited and upcoming financial statements and audit reports on the financial statements."<sup>38</sup>

In addition, we note the OCA Study also followed up on similar work conducted by the SEC Office of Economic Analysis (OEA). From in-depth interviews of a sample of 30 users of financial statements, including lenders, securities analysts, auditors, rating agencies, and other investors, the OEA found that "financial statement users . . . generally regarded [Section 404(b)] disclosures to be beneficial and indicated that . . . Section 404(b) compliance has had a positive impact on their confidence in issuers' financial statements."<sup>39</sup>

We also note that the Center for Audit Quality's 2018 Main Street Investor Survey found that 74% of investors expressed confidence in the U.S. capital market system in 2018.<sup>40</sup> We believe that confidence likely stems, at least in part, from the important safeguards that currently exist in our financial reporting system, including the ICFR auditor attestation requirement.

Finally, we note the Ge/Koester/McVay study cited above that estimated significant costs of the existing exemption from delayed remediation of internal control deficiencies, and costs to

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<sup>35</sup> See, e.g., Letter from Jeff Mahoney, CPA, General Counsel, Council of Institutional Investors et al. to The Honorable Jeb Hensarling, Chairman, House Financial Services Committee et al. at 2 (commenting that exemptions from "Section 404(b) of SOX . . . could have the unintended consequence of eroding investor confidence and the quality of public company financial reporting").

<sup>36</sup> Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, and Cynthia M. Fornelli, Center for Audit Quality, to U.S. Securities and Exchange Commission at 2.

<sup>37</sup> Staff of the Office of the Chief Accountant of the U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million at 102-03 ("In summary, the studies on individuals' judgments involving lending and investing activities imply that auditors' Section 404(b) reports make a difference in 'company risk assessments, probability of extending credit, stock price assessments, internal control strength evaluations, stock purchase recommendations and confidence in financial statements (current and future), as well as audit reports on them.'").

<sup>38</sup> *Id.* at 104.

<sup>39</sup> *Id.* at 49 n.86.

<sup>40</sup> Center for Audit Quality, 2018 Main Street Investor Survey (Sept. 18, 2018), <https://www.thecaq.org/2018-main-street-investor-survey/>.

investors paying too much for shares overvalued due to lack of market information on internal control weaknesses.

**SEC QUESTION: We request comment on the alternative of requiring or permitting prominent disclosure of whether an ICFR auditor attestation is provided, either in addition to, or in lieu of, amendments to the accelerated filer and large accelerated filer definitions. For example, what would be the economic effects of requiring issuers to prominently identify whether they voluntarily comply with the ICFR auditor attestation requirement, such as adding a check box to the cover page of appropriate filings? Would such disclosure result in more voluntary compliance with the ICFR auditor attestation requirement? Could prominent disclosure of whether an ICFR auditor attestation is included have the unintended consequence of confusing investors, such as by leading some investors to incorrectly interpret the cover page disclosure as a sign of effective ICFR even if the more detailed disclosure included in the ICFR auditor attestation report shows otherwise?<sup>41</sup>**

**CII RESPONSE:** CII would support the SEC requiring or permitting issuers that are currently exempt from the ICFR auditor attestation requirement to prominently disclose on the cover page of their annual Form 10-K whether an ICFR audit has been performed. We agree with the Commission that such a disclosure “would make it easier for investors to identify issuers that undergo a voluntary ICFR auditor attestation with only minimal additional disclosure expense for registrants [and] . . . may enhance the value to issuers of pursuing an ICFR auditor attestation even when it is not required.”<sup>42</sup>

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Thank you for consideration of our views. If we can answer any questions or provide additional information with respect to this letter, please do not hesitate to contact me.

Sincerely,



Jeffrey P. Mahoney  
General Counsel

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<sup>41</sup> 84 Fed. Reg. at 24,919.

<sup>42</sup> *Id.* at 24,917.