



Via Email

December 1, 2010

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

*Re: File Number S7-29-10—Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance With Section 404(b) of the Sarbanes-Oxley Act (Study)*¹

Dear Ms. Murphy:

I am writing on behalf of the Council of Institutional Investors (Council), a nonprofit association of public, union and corporate pension funds with combined assets that exceed three trillion dollars. Member funds are major shareowners with a duty to protect the retirement assets of millions of American workers.²

The Council appreciates the opportunity to provide its views on the above referenced Study that raises important issues of interest to our members in their role as institutional investors. On average, Council members have almost 50 percent of their domestic equity holdings invested in indexed funds, including significant investments in the Russell 3000 index.³ The Russell 3000 includes companies whose public float is between the \$75 million and \$250 million that is the focus of the Study.⁴

¹ Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act, Exchange Act Release No. 63,108, 75 Fed. Reg. 64,773 (Oct. 20, 2010), available at <http://edocket.access.gpo.gov/2010/pdf/2010-26349.pdf>.

² For more information about the Council of Institutional Investors (Council) and its members, please visit the Council's website at <http://www.cii.org/about>.

³ Council of Institutional Investors, Asset Allocation Survey 2010 at 10 (on file with Council) (indicating that 47.6% of domestic equity investments were passively managed).

⁴ Russell Investments, Market Capitalization Ranges, http://www.russell.com/indexes/data/reconstitution/US_capitalization_ranges.asp (last visited Nov. 30, 2010) (indicating that the low end of the Russell 3000 includes companies with a \$112 million in market capitalization).

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The Sarbanes-Oxley Act of 2002 (SOX)⁵ was enacted in response to a shocking series of corporate scandals, including many resulting, at least in part, from lax or inadequate internal controls.⁶ The costs of these scandals—from company-specific losses to a widespread loss of confidence in the integrity of the U.S. capital markets—were staggering.⁷ All investors in the U.S. markets, from large institutional investors to individuals investing their hard-earned savings, were impacted by these frauds.

The internal control requirements of Section 404 are a core element of SOX and play a vital role in restoring and maintaining investor confidence in the markets.⁸ Consistent with the language and intent of Section 404, the Council believes any company tapping the public markets to raise capital, regardless of the dollar amount of public float, should have appropriate internal controls in place and should have those controls annually attested to by an independent external auditor.

More specifically, and with regard to the focus of the Study, the Council continues to believe that it is in the best interests of investors to require all public companies to fully comply with Section 404(a) *and* (b).⁹ Our view is validated by existing data.

Two recent studies appear particularly relevant. First, a review of SOX 404 disclosures and subsequent restatements by Audit Analytics found that those companies that complied with the auditor attestation requirement of Section 404(b) had significantly lower rates of restatement.¹⁰

⁵ The Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 (July 30, 2002), *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf>.

⁶ See, e.g., Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting 1998-2007, An analysis of U.S. Public Companies 4* (May 2010),

<http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf> (“[T]he U.S. experienced an unprecedented spate of large company accounting frauds in 2001 and 2002”) [hereinafter *Coso*].

⁷ See, e.g., John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 *J. Econ. Persp.* 91 (2007), *available at* <http://blogs.law.harvard.edu/corpgov/files/2007/03/20070302%20JEP%20Article.pdf> (Noting that prior to the passage of the Sarbanes-Oxley Act on July 25, 2002, “stock market indices of large capitalization stocks had fallen 40 percent over the preceding 30 months.”).

⁸ See, e.g., News Release, *FEI Survey: Average 2007 SOX Compliance Cost \$1.7 Million* (Apr. 30, 2008), <http://fei.mediaroom.com/index.php?s=43&item=204> (69.1% of corporate executives surveyed “agreed that compliance with Section 404 has resulted in more investor confidence in their financial reports”).

⁹ See, e.g., Letter from Cynthia Fornelli, Executive Director, Center for Audit Quality et al. to House and Senate Conferees, *Wall Street Reform and Consumer Protection Act Conference 2* (June 15, 2010), http://www.aicpa.org/Advocacy/Issues/DownloadableDocuments/404b/CAQ_CII_CFA_Institute_letter_to_Conferees_RE_SOX_404_b_%2061510.pdf (urging the House and Senate conferees to “strike from the conference report the Section 404(b) compliance waiver”).

¹⁰ Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestations Filers and (2) Management-Only Report Filers 4* (Nov. 2009), <http://www.complianceweek.com/s/documents/AARestatemnts2.pdf>.

Second, a review of restatements, Sox 404 disclosures and stock prices by Glass, Lewis at the request of the Ohio Public Employees Retirement System found that the stock price of companies that had restatements prior or subsequent to disclosure of internal control weaknesses underperformed market benchmarks by more than 10 percentage points.¹¹ The combined results of these two studies indicate the significant benefits that Section 404(b) provides to investors and the capital markets.

In addition, the Study should acknowledge that while some of the best known financial statement frauds resulting from poor internal controls have occurred at large public companies such as Enron and WorldCom, most financial statement frauds occur at smaller companies. For example, a recent analysis of financial statement fraud cases over the last ten years found that “companies committing fraud had median revenues and total assets just under \$100 million”¹² That same analysis identified the often devastating impact of financial statement fraud on long-term investors, noting:

In addition to the negative stock market reactions to news announcements about alleged fraud or fraud investigations, many fraud firms suffered long-term consequences, including bankruptcy, delisting by national exchanges, and material asset sales. Twenty-eight percent of fraud firms were bankrupt or liquidated within two years from the year in which the SEC issued the last AAER related to the fraud, and 47 percent were delisted from a national stock exchange. Material asset sales also affected about 62 percent of fraud companies. These rates of occurrence were significantly higher than the experiences of no-fraud firms during those periods.¹³

¹¹ *Glass, Lewis Finds Poor Internal Controls at Smaller Companies Hurt Investors*, 14 Council Governance Alert (Dec. 10, 2009) (research data on file with Council), <http://www.cii.org/UserFiles/file/resource%20center/council%20governance%20alert/2009%20Archive/2009%20Alert%2048.pdf> (“[T]he data ‘show that these companies’ internal control problems are at least correlated with poor performance, if not one of the main causes of their underperformance.”).

¹² Coso, *supra* note 6, at 2.

¹³ *Id.* at 6.

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Finally, we believe the decision about whether public companies should be required under the federal securities law to fully comply with Section 404(b) should be based on the views of the companies' shareowners rather than the companies' lobbyists.¹⁴ We note that a 2010 survey of investors by the Center for Audit Quality found that 65 percent of respondents are concerned about the exemption from Section 404(b) for companies with less than \$75 million in public float.¹⁵ More importantly, for purposes of the Study, the survey also found that 81 percent of investors are concerned about the possibility that Congress may extend the exemption to larger companies.¹⁶

We appreciate the opportunity to provide input to the Study. As the U.S. Securities and Exchange Commission (Commission) prepares its report for Congress, we encourage the Commission to take into consideration the views of institutional investors and the qualitative and quantitative evidence demonstrating the importance of compliance with Section 404 and the benefits it has provided to investors and the capital markets. If you have any questions or need any additional information, please feel free to contact me at 202.261.7081 or jeff@cii.org.

Sincerely,



Jeff Mahoney
General Counsel

¹⁴ Letter from the American Bankers Association et al. to The Honorable Christopher Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs et al. 1 (Apr. 22, 2010), <http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/66392/Section404exempt42210.pdf> (letter from coalition of lobbying groups advocating exemption from Section 404(b) without given consideration to the views of the shareowners of the companies they represent).

¹⁵ The CAQ's Fourth Annual Individual Investor Survey, "The Main Street Investor Survey," Key Findings 13 (Sept. 2010), <http://www.thecaq.org/newsroom/pdfs/2010SummaryInvestorSurvey.pdf> ("Investors are concerned about exempting companies from an existing regulation that requires independent auditors to evaluate the systems companies use for generating their financial information.").

¹⁶ *Id.*