



March 29, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Subject: NASDAQ Internal Audit Function Requirement (SR-NASDAQ-2013-032)

Dear Ms. Murphy:

The Society of Corporate Secretaries & Governance Professionals appreciates the opportunity to comment on the NASDAQ proposed rule that would require listed companies to have an internal audit function.¹

Founded in 1946, the Society is a professional membership association of more than 3,000 corporate and assistant secretaries, in-house counsel, outside counsel and other governance professionals who serve approximately 1,600 entities, including 1,200 public companies of most every size and industry. Society members are responsible for supporting the work of corporate boards of directors and the executive managements of their companies on corporate governance and disclosure matters, including enterprise risk assessment and oversight of internal controls.

Introduction

Under the proposed rule, NASDAQ-listed companies generally would be required to formally establish and maintain an internal audit function.² The rulemaking notice

¹ SEC Release 34-69030

² NYSE Listed Company Manual (LCM) Section 303A.07(c) has a similar requirement. “Each listed company must have an internal audit function.” *Commentary*: “Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control. A company may choose to outsource this function to a third party service provider other than its independent auditor.”

NYSE LCM Section 303A.07(b)(iii)(F) *Commentary*: “The review should also include discussion of the responsibilities, budget and staffing of the company’s internal audit function.”

NYSE LCM Section 303A.07(b)(iii)(E) the Audit Committee should “meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors. *Commentary*: “As noted herein, all listed companies must have an internal audit function.”

describes three purposes for the proposed rule: (1) to ensure that listed companies have a mechanism in place to regularly review and assess their system of internal control; (2) to ensure that the listed company's management and audit committee are provided with ongoing assessments about risk management processes and the system of internal control; and (3) to assist listed companies' efforts to comply with federal securities laws regarding evaluation of the effectiveness of internal controls over financial reporting.

The rule would require the internal audit function to report solely to the audit committee of the board of directors.³ The rule would permit listed companies to outsource the internal audit function, subject to certain limitations.⁴

The Society believes that all three stated policy purposes for the rule are adequately addressed by existing laws and rules. Listed companies are currently required use a variety of mechanisms to review and assess their internal control systems and to provide their management, boards of directors and audit committees with information about their company's risk management processes and their internal controls.⁵ Similarly, listed companies already employ various processes to comply with federal securities laws regarding periodic evaluations of the effectiveness of internal controls over financial reporting.⁶ We are not aware of any evidence that listed companies have not been properly carrying out the functions that would be served by the proposed rule.

Listed companies should be permitted the flexibility to design and implement approaches to assess risks and internal controls that are suitable to their particular size, industry, risk profile and other circumstances. Some companies may assign the tasks to various internal departments and/or various external consultants. The rulemaking notice recognizes the value of providing flexibility to listed companies by permitting the mandated function to be outsourced. We believe, however, that decisions on the use of a single or multiple department(s) or consultant(s) should continue to be left up to a listed company's management and board of directors.

The Proposed Rule Should Apply Only to Financial Reporting Risk

The Society is concerned that the proposed rule could be interpreted to have no limit on the scope of risks that an internal audit function would be required to assess. There are many types of risks facing listed companies, such as financial risk, (including liquidity, credit, currency, and interest rate, risk to name a few), strategic risk, operational risk, cyber risk, legal and compliance risk, and brand risk.⁷ Moreover, certain industries have significant risk exposures outside the financial reporting areas. The nature of these unique industry risks is such that technical expertise, other than financial

³ The rulemaking notice states that, "in all instances, the audit committee has sole responsibility to oversee the internal audit function and cannot allocate or delegate this responsibility to another board committee."

⁴ Under the proposed rule, the internal audit function could not be outsourced to the listed company's independent auditor.

⁵ See NASDAQ listing rule 5605(c).

⁶ *Id.*

⁷ See COSO's publication Enterprise Risk Management – Integrated Framework.

literacy/expertise, is critical in order to provide comprehensive board oversight.

Examples include:

- Airline – safety and security issues, fuel costs/hedging
- Chemicals – environmental, product quality and reliability, worker and community safety
- Food, Beverage, Consumer Products – product quality/safety/anti-tampering, environmental, obesity, genetically engineered ingredients
- Energy/Utility – environmental, nuclear fuel storage and disposal, security and reliability issues, worker and community safety
- Manufacturing (auto, aircraft, heavy equipment, medical devices) – environmental, product and worker safety
- Pharmaceutical – regulatory (clinical trials, labeling, manufacturing and marketing of drugs, drug safety and counterfeiting)

If the intent of the proposed rule is to require the internal audit function to provide management and the audit committee with ongoing assessments of the listed company's risk management processes for each of the various types of risk, we believe it goes too far. We recommend that the rule narrow and specify that the rule apply to financial reporting risk only.

Similarly, there seems to be no limit on the types of internal controls that the internal audit function would be required to assess. The rulemaking notice refers both to a *system of internal control* and to *internal control over financial reporting*. The implication is that a system of internal control is broader than internal controls over financial reporting. For example, the proposed rule could be interpreted to require assessments of information technology controls, operational risk controls, disclosure controls, and compliance controls. Again, we recommend that the rule narrow and clarify its scope to internal controls over financial reporting only.

The Society believes that audit committees should not be required to oversee all types of risk and internal controls. The proposed rule would require the internal audit function to report solely to the audit committee. We are concerned that the implication is that the audit committee is, therefore, not responsible for merely financial risks and financial reporting, but is responsible for all facets of risk and internal controls. We note that the New York City Bar Association's Financial Reporting Committee recently asked the NYSE to reconsider its rule placing responsibility for oversight of risk management within the audit committees of NYSE listed companies.⁸ The Society concurs with the City Bar Association's concern about SRO listing requirements that could be interpreted to impose on audit committees such broad risk and controls oversight responsibility. The board of directors of a listed company should be able to delegate risk management and internal controls oversight among its various committees or to the full board. For example, a listed company might choose to have a finance committee, a science and

⁸ Letter dated March 5, 2013. <http://www2.nycbar.org/pdf/report/uploads/20072409-NYSEListedCompanyRules.pdf>

technology committee, a compliance committee, a quality and safety committee, and a risk committee.

The Proposed Rule Should Allow for Multiple Outsource Providers

The rulemaking notice refers to a singular “third party” and “function.” The rule therefore appears to imply either a single internal audit function or a single outsourced provider. If the proposed rule purports to require an internal audit function for all risks, the Society recommends that listed companies be permitted to allocate these assessment functions to more than one internal unit, and to more than one external vendor, with different internal and external organizations providing assessments of various types of risks.

Currently, listed companies may allocate to multiple relevant units in the enterprise (and/or outside the enterprise) various categories of risk management and internal control assessments. For example, a listed company could have a risk management department with responsibility for insurance; a treasury department with responsibility for investment and currency risks; and an internal audit function with responsibility for financial reporting. A listed company might outsource to one vendor the periodic assessment of the company’s cyber security risk management and related controls, such as to conduct external penetration testing, but not overall risk assessment or internal controls. The Society believes that these distributed responsibility approaches can be as effective as – and possibly more effective than -- the centralized approach contemplated by the proposed rule. A centralized internal audit function may duplicate the work performed by specialized employees or consultants while providing little benefit to companies or their investors.

Moreover, a listed company’s internal audit function – whether home-grown or outsourced – may not have the breadth of skills or sufficient personnel or other resources to be able to assess all aspects of enterprise risk management and all types of internal controls. Using specialists to assess and help manage particular aspects of risk and controls may provide efficiency, cost and risk mitigation benefits to companies and investors which are greater than what can be provided by mandatory oversight by generalists.

The Period for Implementation of the Proposed Rule, If Approved, Should be Lengthened

The Society believes the time in which listed companies must implement the proposed rule is inadequate. Although larger NASDAQ companies are more likely to have an internal audit function, we believe there are many smaller listed companies that do not currently have an internal audit function. These companies would require adequate time to locate, qualify and hire sufficient personnel to perform the broadly-described assessment functions. Similarly, we believe some listed companies have contractual commitments with multiple vendors to outsource aspects of these functions. Those commitments may extend beyond the proposed effective date for the rule. Accordingly,

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we suggest that the effective date be delayed until the end of the first full calendar year following the year in which the rule is approved (*i.e.*, December 31, 2014, if the rule is adopted in 2013).

The Comment Period Should be Extended to Solicit Further Comments as to Costs and Benefits of the Proposed Rule

The Society notes that the rulemaking notice contains statements about NASDAQ's purpose, intent and belief about the benefits of the proposed rule. The Society respectfully suggests that in light of the short three-week comment period, listed companies should be given more time to express their opinions on the need or benefits of the proposed rule.

The Society is not aware of any analysis of the cost and burdens of the proposed rule on NASDAQ-listed companies generally, and on smaller companies in particular. We recommend that such an analysis be conducted before implementing a rule requiring listed companies to create new internal audit functions or to outsource broad assessments of risk management and internal controls.

Conclusion

For all of these reasons, we suggest that the proposed rule: (1) be clarified to limit its scope to financial reporting risk and internal controls over financial reporting risk only; (2) allow outsourcing of the internal audit function to multiple providers (whether or not the scope is limited); and (3) have an effective date no earlier than the end of the first full calendar year following the year in which the rule is approved.

Sincerely,



Kenneth Bertsch
President & CEO

cc: The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
The Honorable Daniel M. Gallagher
Lona Nallengara, Acting Director, Division of Corporation Finance