



July 29, 2019

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Amendments to the Accelerated Filer and Large Accelerated Filer Definitions (Release No. 34-85814; File No. S7-06-19)

Dear Ms. Countryman:

Better Markets¹ appreciates the opportunity to comment on the above-captioned proposal (“Proposal” or “Release”) released for public comment by the Securities and Exchange Commission (“SEC” or “Commission”). The Commission is proposing to amend the definitions of “Accelerated Filer” and “Large Accelerated Filer” under its rules to now deem hundreds of additional public companies that have less than \$100 million in revenue and less than \$700 million in public float as “non-accelerated filers.”

As a result of the amendments, these companies would not be required to have their management’s assessment of the effectiveness of internal control over financial reporting attested to and reported on by an independent, outside auditor. In short, this change would remove the requirements under Section 404(b) of the Sarbanes-Oxley Act (“SOX 404(b)”) but maintain the Act’s Section 404(a) requirements which require that these companies establish and maintain effective internal controls over financial reporting (“ICFR”). In addition, the proposed amendments would increase the transition thresholds for Accelerated and Large Accelerated filers becoming non-accelerated filers and add a revenue test to the transition thresholds for exiting both

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

Accelerated and Large Accelerated filer status.² Our letter focuses on the proposal to remove the SOX 404(b) requirements.

SUMMARY

The Proposal, if approved, will

1. decrease the quality of financial reporting,
2. weaken internal controls,
3. increase the number of accounting misstatements and restatements,
4. increase the opportunity for struggling companies and executives to commit fraud,
5. reduce the ability of regulators to detect and deter fraud,
6. restrict investors from protecting themselves by removing an important source of information,
7. diminish market integrity, and
8. harm investor confidence.

We are not alone in holding these views. There are dozens of academic studies,³ governmental reports (*including two from the SEC itself*), Congressional testimony, business surveys, etc., that demonstrate that requiring independent auditor attestation for management's report of ICFR improves the quality of financial reporting,⁴ reduces the cost of capital,⁵ increases the valuation of the company,⁶ significantly improves internal controls,⁷ reduces the number of restatements,⁸ and reduces the likelihood of fraud.⁹

² See Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, Release No. 34-8581; File No. S7-06-19, 84 Fed. Reg. 24876 (May 29, 2019) available at <https://www.federalregister.gov/documents/2019/05/29/2019-09932/amendments-to-the-accelerated-filer-and-large-accelerated-filer-definitions>, at 24,876.

³ See John C. Coates & Suraj Srinivasan, *SOX after Ten Years: A Multidisciplinary Review* 28 ACCOUNTING HORIZONS 627 (2014), available at <https://aaapubs.org/doi/10.2308/acch-50759>. This is a meta-study, reviewing over 120 academic papers, concluding that the policy prescriptions implemented since the enactment of Sarbanes-Oxley Act and the institutions it created has generally improved financial reporting and compliance costs have fallen.

⁴ See STAFF OF THE 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 ("Staff SOX Study") at 7 (Apr. 2011), available at <https://www.sec.gov/news/studies/2011/404bfloat-study.pdf>.

⁵ See Release at 24,905 for several references to academic studies showing material weaknesses in ICFRs lead to restatements, which in turn result in low earnings and higher cost of debt or equity capital.

⁶ By one study, companies that comply with SOX 404(b) could command over 18% more valuation than similarly situated companies that do NOT comply with SOX 404(b). See also Hongmei Jia, Hong Xie, & David Ziebart, *An Analysis of the Costs and Benefits of Auditor Attestation of Internal Control over Financial Reporting*, Working Paper (2014), available at <https://www.lsu.edu/business/accounting/files/researchseries/20141027JXZ.PDF>.

⁷ See STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, STUDY OF THE SARBANES-OXLEY ACT OF 2002 SECTION 404 INTERNAL CONTROL OVER FINANCIAL REPORTING REQUIREMENTS at 6 (Sept. 2009), available at https://www.sec.gov/news/studies/2009/sox-404_study.pdf.

⁸ See Release at 24,894.

⁹ See Dain C. Donelson, Matthew S. Ege, and John M. McInnis, *Internal Control Weaknesses and Financial Reporting Fraud*, (2017), 36 AUDITING 45 (2017) available at <https://aaapubs.org/doi/10.2308/ajpt-51608>.

Even more telling is the fact that the Proposal itself is replete with analysis, discussion, and predictions about the negative impact of the amendments. Despite all this *overwhelming and unrefuted evidence*, the Commission is proposing to destroy an effective investor protection mechanism—all in the name of supposed miniscule saving of compliance costs.

The Commission’s mission is to “protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation”¹⁰ and, presumably, not to serve as a de facto cost-cutting agent to managers of certain issuers. The Proposal would harm investors by increasing the probability of fraud; it will create less efficient markets by further bifurcating markets and fragmenting regulatory requirements over public companies; and, it will increase the cost of capital for companies, as investors would require a premium to invest in companies with ineffective internal controls.

Given these significant harmful effects and the lack of justifiable basis for the changes, the Commission should not approve the Proposal.

COMMENTS

The Proposal Would Weaken Internal Controls Over Financial Reporting.

The independent auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act serves as an effective check on a company’s CEO and CFO as they establish, maintain, and personally report on the effectiveness of the company’s internal control over financial reporting. These internal controls over financial reporting include, but are not limited to:

1. whether companies have processes designed to provide reasonable assurance that the company’s transactions are properly authorized;
2. that the company’s assets are safeguarded against unauthorized or improper use; and
3. that, the company’s transactions are properly recorded and reported to permit the preparation of the registrant’s financial statements in conformity with generally accepted accounting principles.¹¹

As the Commission and the Commissioners are well-aware, Sarbanes-Oxley was Congress’s bipartisan response to the enormous and confidence-shattering corporate frauds of WorldCom, Enron, and others in 2001-2002. In that law, Congress intended to “address the

¹⁰ See “About the SEC,” <https://www.sec.gov/about.shtml>. Accessed July 23, 2019.

¹¹ See Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33–8138; 34–46701; IC– 25775; File No. S7–40–02, 67 Fed Reg. 66,208 (Oct. 30, 2002), *available at* <https://www.govinfo.gov/content/pkg/FR-2002-10-30/pdf/X02-11030.pdf>, at 66220.

systemic and structural weaknesses affecting [the] capital markets which were revealed by the repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility.”¹²

In particular, Sections 404(a) and 404(b) of the Act sought to “enhance the quality of reporting and increase investor confidence” by requiring that companies include a statement by their management regarding the effectiveness of company’s internal control over financial reporting and require an auditor to attest to and report on the management’s assessment of such controls.¹³

Not requiring this independent attestation and report would allow executives—particularly those at companies facing financial challenges—to either not establish effective ICFRs (which would result in weaker internal controls) or permit the under-reporting or misreporting of ineffective ICFRSs to go undetected. There is ample evidence showing that “non-accelerated” filers—the category of filers the Proposal aims to increase—have significantly less effective ICFRs than other public companies. The Proposal includes the following table showing the disparity between non-accelerated filers and others regarding reported ineffective ICFRs.

TABLE 9—PERCENTAGE OF ISSUERS REPORTING INEFFECTIVE ICFR ¹⁴

Ineffective ICFR year reported in:	Non-accelerated (percent)	Accelerated (percent)	Large accelerated (percent)
Management Report			
2014	40.3	7.8	3.1
2015	41.2	8.8	3.7
2016	38.4	9.3	4.5
2017	40.3	9.4	4.9
<i>Average/year</i>	<i>40.1</i>	<i>8.8</i>	<i>4.1</i>
Auditor Attestation			
2014	n/a	8.0	3.3
2015	n/a	8.8	3.7
2016	n/a	8.9	4.5
2017	n/a	9.6	4.8
<i>Average/year</i>	<i>n/a</i>	<i>8.8</i>	<i>4.1</i>

Source: Release at 24,893, Table 9.

The evidence—from the SEC itself and others as cited above—is clear: over 40% of non-accelerated companies that are not required to have auditor attestation per SOX 404(b) have ineffective ICFR, compared to less than 9% and 5% of Accelerated and Large Accelerated companies, respectively. Furthermore, the Commission also knows that these ineffective controls are not one-off aberrations because over 68% of non-accelerated filers have reported two consecutive years of ineffective ICFR and over 38% have reported four consecutive years of ineffective ICFR in their annual reports.¹⁴

The Commission’s analysis of the impact of removal of the attestation requirement includes the following stark predictions:

¹² See Public Company Accounting Reform and Investor Protection Act of 2002, S. Rept. 107-205 (July 3, 2002), available at <https://www.govinfo.gov/app/details/CRPT-107srpt205/CRPT-107srpt205>, p.2.

¹³ *Id.* at 31.

¹⁴ See Release at 24,893-4.

“Exempting the affected issuers from the ICFR auditor attestation requirement may result, over time, in management at this category of issuers being less likely to maintain effective ICFR, which in turn may result in less reliable financial statements, on average, for these issuers.”¹⁵

That, in turn, increases the likelihood of future restatements, lower earnings quality, higher rate of future fraud revelations, more profitable insider trading, and less accurate analysts’ forecasts.¹⁶ Again, given all these predictable and expected harms, and the Commission’s statutory obligation to protect investors, promote fair and orderly markets, and facilitate capital formation, it remains an incomprehensible mystery to us how the Commission decided to release the Proposal, or how it can conceivably approve the Proposal.

Requiring Independent Auditing of ICFR Protects Investors and Increases Investor and Market Confidence.

The Commission is aware of, and presents ample evidence in the Release, that the audit of ICFR may “encourage management to maintain more effective controls and thereby deter accounting errors and fraud.”¹⁷ The presence of effective ICFRs add to investor confidence,¹⁸ promote market integrity,¹⁹ and enhance capital formation by encouraging investment in public markets.²⁰ SOX 404(b) is an effective mechanism that gives investors and market participants confidence that a company’s management will:

1. establish and maintain effective internal controls;
2. truthfully report on their effectiveness or lack thereof; and
3. if it fails to do either of these, the company’s outside auditor will detect²¹ these deficiencies and report on them through disclosures, independent of the management and the company.

As Commissioner Rob Jackson said in his dissent, “Congress worried that [executives’] certification alone might not deter managers from fudging the numbers, so SOX 404(b) also required outside auditors to give an opinion on management’s claim that controls could ensure

¹⁵ See Release at 24,903.

¹⁶ See Release at 24,904.

¹⁷ See Release at 24,904.

¹⁸ See Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation (July 2013), U.S. Gov’t Accountability Office, GAO–13–582, (“2013 GAO Study”), available at <https://www.gao.gov/assets/660/655710.pdf>, at p.30.

¹⁹ “The potential for market-level impact is largely driven by network effects (which are associated with the broad adoption of practices) and by other externalities (i.e., spillover effects on issuers or parties beyond the issuer in question). For example, to the extent that the ICFR auditor attestation requirement leads to more reliable financial statements at a large number of issuers, it may lead to a more efficient allocation of capital across different investment opportunities at the market level.” See Release at 24,905.

²⁰ See Release at 24,905.

²¹ The ICFR auditor attestations “generally resulted in the identification and disclosure of material weaknesses that were not previously identified or whose severity was misclassified when identified by management in its assessment of ICFR, and that investor risk assessments and investment decisions were associated with the findings in auditor attestation reports.” See Release at 24,903.

accurate disclosure to investors. The idea was that, knowing that auditors would review their work, management would be more honest about controls.”²²

The information that a company has independent auditor attestation of its ICFR, as shown by several studies, can then be factored into the total mix of information an investor or analyst needs to make informed investment decisions.²³ Additionally, as a Government Accountability Office study showed, companies that are **not** required to have independent auditor attestation have higher rates of financial restatements.²⁴

Some of these restatements can have significant impact on investors. While the Commission has unjustifiably failed to conduct concrete investor harm analysis, attributable to restatements, a recent study by a group of professors sheds some light on the matter. The study found that in 2018 alone, 11 companies (that—should the Proposal be approved as released—would be exempted from SOX 404(b) requirements) announced restatements totaling more than \$65 million, and that these restatements erased more than \$294 million in market value.²⁵ The loss to investors stemming from these restatements alone are about four times the total purported compliance cost savings per year the Proposal aims to achieve.²⁶ This cost-benefit analysis alone should compel the Commission to not approve the Proposal.

CONCLUSION

The Commission has no evidentiary or other basis or reasonable public policy rationale to rescind a proven effective investor protection and market integrity regulatory tool. The claim that costs associated with ICFR attestation represents a “significant cost”²⁷ for issuers is preposterous given that, for the average covered company, the cost savings would amount to 0.48% of revenue

²² See Statement on Proposed Amendments to Sarbanes-Oxley 404(b) Accelerated Filer Definition, Commissioner Rob Jackson (May 9, 2019), available at <https://www.sec.gov/news/public-statement/jackson-statement-proposed-amendments-accelerated-filer-definition>. Accessed July 23, 2019.

²³ See Investor Demand for Internal Control Audits of Large U.S. Companies: Evidence from a Regulatory Exemption for M&A Transactions, Robert R. Carnes, Dane M. Christensen, and Phillip T. Lamoreaux (2019), the Accounting Review, January 2019, Vol. 94, available at <https://aaajournals.org/doi/abs/10.2308/accr-52045>.

²⁴ See 2013 GAO Study at 12.

²⁵ See Letter Re: Amendments to the Accelerated Filer and Large Accelerated Filer Definitions - File No. S7-06-19, Mary Barth, Stanford University; Wayne Landsman, University of North Carolina; Joseph Schroeder, Indiana University; and, Daniel Taylor, University of Pennsylvania (July 11, 2019), (“Professors Letter”), available at <https://www.sec.gov/comments/s7-06-19/s70619-5802113-187069.pdf>; see also Dave Michaels, *SEC Plan Gives Audit Relief to Firms that Wiped Out Over \$290 Million*, WALL ST. J. (July 26, 2019), available at <https://www.wsj.com/articles/sec-plan-gives-audit-relief-to-firms-that-wiped-out-over-290-million-11564141784>.

²⁶ If the Proposal is approved as released, the Commission expects 358 issuers would be exempted from SOX 404(b) requirements. The Commission estimates that, on average, exempted issuers will save \$110,000 in audit fees and an additional \$100,000 in non-audit fees associated with ICFR attestation (see Release at 24,901). Based on this estimation, we calculate that the total compliance cost savings will be about \$75 million (the multiple of 358x210,000=75,180,000), for similar breakdown see Table 22 at Release 24,920.

²⁷ See, e.g., Release 24,899, 24,902.

and 0.09% of market value.²⁸ Given the vast amount of evidence showing the benefits of SOX 404(b), markets' decade-long practice with the rule, and investors' and market participants reliance on the attestation, the Commission would do a great disservice to its mission if it approves the Proposal.

Sincerely,



Dennis M. Kelleher
President & CEO

Lev Bagramian
Senior Securities Policy Advisor

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
lbagramian@bettermarkets.com
www.bettermarkets.com

²⁸ Professors Letter at 3.