



Setting the global standard for investment professionals

8 December 2010

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

**Re: Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act** (*File No. S7-29-10*)

Dear Ms. Murphy:

CFA Institute, (“CFA Institute”)<sup>1</sup> appreciates the opportunity to submit the following comments to the U.S. Securities and Exchange (“SEC” or the “Commission”) in response to the Commission’s study, “Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act.” CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, and on issues that affect the efficiency and integrity of global financial markets.

**Executive Summary**

CFA Institute does not support exempting any public companies, but particularly both large accelerated filers (“LAFs”) and accelerated filers (“AFs”), from the requirements of Section 404(b) of the Sarbanes-Oxley Act (“Section 404(b)”) relating to the audit of companies’ internal controls for financial reporting (ICFR) . We believe such exemptions will have negative effects on both investors’ ability to review and analyze potential investments in these companies, and that the exempted issuers themselves will be less rigorous in the design and application of ICFRs. As a result, they will pay with higher long-term capital costs than they would have otherwise had to pay.

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<sup>1</sup> CFA Institute is a global, not-for-profit professional association of nearly 107,000 investment analysts, advisers, portfolio managers, and other investment professionals in 137 countries, of whom nearly 95,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.



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However, because Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) requires exemptions for non-accelerated filers (NACs) from Section 404(b) requirements, we believe the Commission should take steps to prevent confusion among investors. To achieve this goal, we believe the Commission should introduce changes that apply to all companies exempt from the Section 404(b) requirements (“Exempt Issuers”):

- Amend the fourth box on the front page of the Forms 10-K and 10-Q for “Smaller reporting company,” to say, “Company is exempt from the internal control audit requirements of Section 404(b) of the Sarbanes-Oxley Act;” and
- Require Exempt Issuers to prominently disclose in their 10-Ks and 10-Qs that they are exempt from Section 404(b), together with a plain-English description of their internal control mechanisms and how these mechanisms will prevent financial reporting problems.

We believe that these changes will allow investors to, first, recognize which firms are Exempt Issuers and, second, determine whether each company’s description of its internal controls are appropriate for their risk appetites.

### **Purpose for Section 404(b) Internal Control Audits**

We supported the introduction of the Section 404(b) audits of company internal controls in 2002 because of the negative effects the markets endured from faulty, even fraudulent, financial reports published during the dot-com/technology bubble that burst in the early 2000s. The resulting loss of investor confidence in companies and their published financial reports was largely responsible for the Nasdaq Composite Index losing nearly 78 percent of its value between March 2000 and October 2002.

The Sarbanes-Oxley Act of 2002 helped reduce these concerns, in large part due to the requirement that external auditors would subject listed companies to internal control audits. As a consequence of these requirements, more than 3,100 companies reported material internal control weaknesses in the four calendar years between the beginning of 2003 and the end of 2006. Adding to this acknowledgement of inadequate internal controls was the fact that more than 3,800 companies also restated prior periods’ earnings during this period.

We had advocated against exemptions for Exempt Issuers to avoid a repeat of this history. As a consequence of Section 989G(b) in Dodd-Frank, however, investors will now have to determine whether the companies they are considering for investment have been subjected to Section 404(b)-type internal controls audit or not. Without changes to help them with these determinations, this provision could result in losses for investors due to faulty financial reporting and restatements and, ultimately, higher capital costs for Exempt Issuers due to a lack of trust.



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### **Suggested Modifications to SEC Reporting Requirements**

To prevent these kinds of problems, we urge the Commission to provide increased disclosures that would enable investors to distinguish between Exempt Issuers and those who remain subject to Section 404(b) internal control audits. To accomplish this, CFA Institute proposes two specific changes.

Amended Descriptions for NACs. As proposed in 2005, registered companies have to check a box on the front pages of their 10-Ks and 10-Qs to denote their filing status.<sup>2</sup> We propose to change the fourth of these boxes, the one currently for “Smaller reporting company,” to something that enables investors to more directly distinguish between those firms that are subject to the Section 404(b) internal control audit requirements of the Sarbanes-Oxley Act of 2002, and those that are exempt from those requirements.

To this end, we suggest changing the language for the fourth box to read, “Company is exempt from the internal control audit requirements of Section 404(b) of the Sarbanes-Oxley Act.” Providing this information on the front page of these important Forms will enable investors to quickly recognize which firms have or have not been subject to these internal control audits. This change also will alert them to the need to review and consider additional disclosures for inclusion in these Forms, as well (see description immediately below), so that they can determine whether or not the risk created by this exemption is acceptable.

### Require Prominent Discussion of Internal Controls for Exempt Issuers

Checking the box on the front pages of Forms 10-K and 10-Q should be the first of two disclosures that Exempt Issuers should have to provide in exchange for not having to comply with the internal control requirements of Sarbanes-Oxley’s Section 404(b). The second disclosure should include three pieces of information, presented prominently within these Forms, and written in plain English:

- a substantive reasoning for why the issuer has taken advantage of the exemption;
- a description of the internal controls the issuer has in place to prevent faulty or fraudulent financial reports; and
- why management believes these controls are sufficient, or not, to prevent faulty or fraudulent financial reports.

The goal of these disclosures is to give an indication of how robust each Exempt Issuer’s internal control mechanisms are so that investors can decide whether or not the description alleviates any concerns they may have about the risk of future financial restatements or worse.

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<sup>2</sup> See <http://www.sec.gov/rules/proposed/33-8617fr.pdf>, page 56865.



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When an Exempt Issuer has to restate its financial reports, we suggest that its disclosure also describe why the internal controls previously in place were not sufficient to prevent the mistake, what changes were made as a consequence of the restatement, and why management thinks the changes will prevent future reporting problems.

### **Conclusion**

While we are concerned about the prospect of a large majority of small, publicly-traded companies being further exempted from the internal control audit requirements that were soon to be required, we recognize that these exemptions are now the law. Hence, to ensure investors are not basing investment decisions on a mistaken impression that the ICFRS of this large group of firms have been officially audited, additional disclosures are indicated. If circumstances warrant, this exemption should be reconsidered if it becomes clear that small issuers are consistently demonstrating that more rigorous internal-control oversight is needed. Should you have any questions about our positions, please do not hesitate to contact me at [kurt.schacht@cfainstitute.org](mailto:kurt.schacht@cfainstitute.org), or 212.756.7728; or [james.allen@cfainstitute.org](mailto:james.allen@cfainstitute.org), or 434.951.5558.

Sincerely,

A handwritten signature in black ink that reads 'Kurt N. Schacht'.

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA  
Managing Director, Standards and  
Financial Market Integrity Division  
CFA Institute

A handwritten signature in black ink that reads 'James C. Allen'.

/s/ James C. Allen

James C. Allen, CFA  
Head, Capital Markets Policy  
CFA Institute