Council of Institutional Investors
The Voice of Corporate Governance

Via Hand Delivery

March 1, 2012

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Johnson and Ranking Member Shelby:

As a nonprofit, nonpartisan association of public, corporate and union pension plans, and other employee benefit funds, foundations and endowments with combined assets that exceed $3 trillion, the Council of Institutional Investors (Council) is committed to protecting the retirement savings of millions of American workers.[1] With that commitment in mind, and in anticipation of your upcoming March 6 hearing entitled "Spurring Job Growth Through Capital Formation While Protecting Investors, Part II," we would like to share with you some of our concerns and questions about S. 1933, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011."

Our questions and concerns about S. 1933 are grounded in the Council's membership approved corporate governance best practices.[2] Those policies explicitly reflect our members' view that *all* companies, including "companies in the process of going public should practice good corporate governance."[3] Thus, we respectfully request that the Committee consider changes to, or removal of, the following provisions of S. 1933:

Definitions

We question the appropriateness of the qualities defining the term "emerging growth company" (EGC) as set forth in Sec. 2(a) and 2(b).

[1] For more information about the Council of Institutional Investors (Council) and our members, please see our website at www.cii.org.
[2] Council of Institutional Investors, Corporate Governance Policies (Last updated Dec. 21, 2011) [hereinafter Policies] http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2012-21-11%20FINAL%20(2).pdf.
[3] *Id.* § 1.7 Governance Practices at Public and Private Companies.

As you are aware, under Sec. 2(a) and 2(b) a company would qualify for special status for up to five years, so long as it has less than $1 billion in annual revenues and not more than $700 million in public float following its initial public offering (IPO). The Council is concerned that those thresholds may be too high in establishing an appropriate balance between facilitating capital formation and protecting investors.

For example, we note that some of the most knowledgeable and active advocates for small business capital formation have in the past agreed that a company with more than $250 million of public float generally has the resources and infrastructure to comply with existing U.S. securities regulations.[4] We, therefore, urge the Committee to reevaluate the basis for the proposed thresholds defining an EGC.

Disclosure Obligations

We have concerns about Sec. 3(a)(1) because it would effectively limit shareowners' ability to voice their concerns about executive compensation practices.

More specifically, Sec. 3(a)(1) would revoke the right of shareowners, as owners of an EGC, to express their opinion collectively on the appropriateness of executive pay packages and severance agreements.

The Council's longstanding policy on advisory shareowner votes on executive compensation calls on all companies to "provide annually for advisory shareowner votes on the compensation of senior executives."[5] The Investors Working Group echoed the Council's position in its July 2009 report entitled *U.S. Financial Regulatory Reform: The Investors' Perspective*.[6]

Advisory shareowner votes on executive compensation and golden parachutes efficiently and effectively encourage dialogue between boards and shareowners about pay concerns and support a culture of performance, transparency and accountability in executive compensation. Moreover, compensation committees looking to actively rein in executive compensation can utilize the results of advisory shareowner votes to defend against excessively demanding officers or compensation consultants.

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[4] *See* 2010 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report 18 (June 2011), http://www.sec.gov/info/smallbus/gbfor29.pdf (citing recommendation to "[i]ncrease the amount of public float in the definition of 'smaller reporting company' from $75 million to $250 million" as a high priority).

[5] Policies, *supra* note 2, § 5.2 Advisory Shareowner Votes on Executive Pay.

[6] Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 23 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf. Following its issuance, the Investors' Working Group (IWG) Report was reviewed and subsequently endorsed by the Council board and membership. For more information about the IWG, please visit the Council's website at http://www.cii.org/iwgInfo.

The 2011 proxy season has demonstrated the benefits of nonbinding shareowner votes on pay. As described in *Say on Pay: Identifying Investors Concerns*:

> Compensation committees and boards have become much more thoughtful about their executive pay programs and pay decisions. Companies and boards in particular are articulating the rationale for these decisions much better than in the past. Some of the most egregious practices have already waned considerably, and may even disappear entirely.[7]

As the Committee deliberates the appropriateness of disenfranchising certain shareowners from the right to express their views on a company's executive compensation package, we respectfully request that the following factors be considered:

1. Companies are not required to change their executive compensation programs in response to the outcome of a say on pay or golden parachutes vote. Securities and Exchange Commission (SEC) rules simply require that companies discuss how the vote results affected their executive compensation decisions.

2. The SEC approved a two-year deferral for the say on pay rule for smaller U.S. companies. As a result, companies with less than $75 million in market capitalization do not have to comply with the rule until 2013, thus the rule's impact on IPO activity is presumably unknown. We, therefore, question whether there is a basis for the claim by some that advisory votes on pay and golden parachutes are an impediment to capital formation or job creation.

We also have concerns about Sec. 3(a)(2) because it would potentially reduce the ability of investors to evaluate the appropriateness of executive compensation.

More specifically, Sec. 3(a)(2) would exempt an EGC from Sec. 14(i) of the Securities Exchange Act of 1934, which would require a company to include in its proxy statement information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

We note that the SEC has yet to issue proposed rules relating to the disclosure of pay versus performance required by Sec. 14(i). As a result, no public companies are currently required to provide the disclosure. We, therefore, again question whether a disclosure that has not yet even been proposed for public comment is impeding capital formation or job creation.[8]

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[7] Robin Ferracone & Dayna Harris, *Say on Pay: Identifying Investor Concerns* 21 (Sept. 2011), http://www.cii.org/UserFiles/file/resource%20center/publications/Say%20On%20Pay%20-%20Identifying%20Investor%20Concerns.pdf.

[8] Similarly, Sec. 3(a)(3) of S. 1933 would exempt emerging growth companies from the disclosure of the ratio of CEO to median employee compensation required by Section 953(b)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, notwithstanding that the Securities and Exchange Commission has yet to even issue a proposal for public comment relating to that disclosure. While the Council does not have a position on this specific disclosure, § 5.1 of the Council's policies state: "It is the job of the board of directors and the compensation committee specifically to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as . . . *compensation paid to other employees*" (emphasis added).

Our membership approved policies emphasize that executive compensation is one of the most critical and visible aspects of a company's governance. Executive pay decisions are one of the most direct ways for shareowners to assess the performance of the board and the compensation committee.[9]

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term.[10] It is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance.[11]

Transparency of executive compensation is a primary concern of Council members.[12] All aspects of executive compensation, including all information necessary for shareowners to understand how and how much executives are paid should be clearly, comprehensively and promptly disclosed in plain English in the annual proxy statement.[13]

Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and the board in setting executive pay, to assess pay-for-performance links and to optimize their role in overseeing executive compensation through such means as proxy voting.[14] It is, after all, shareowners, not executives, whose money is at risk.[15]

Accounting and Auditing Standards

We have concerns about Sec. 3(c) and Sec. 5 because those provisions would effectively impair the independence of private sector accounting and auditing standard setting, respectively.

More specifically, Sec. 3(c) would prohibit the independent private sector Financial Accounting Standards Board from exercising their own expert judgment, after a thorough public due process in which the views of investors and other interested parties are solicited and carefully considered, in determining the appropriate effective date for new or revised accounting standards applicable to EGCs.

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[9] Policies, *supra* note 2, § 5.1 Introduction.
[10] *Id.*
[11] *Id.*
[12] *Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance*: *Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 14 (full text July 29, 2009) (statement of Ann Yerger, Executive Director, Council of Institutional Investors) [hereinafter Yerger] http://www.cii.org/UserFiles/file/testimony/07-29-09%20Ann%20Testimony%20FINAL%20(with%20all%20attachments).pdf.
[13] Policies, *supra* note 2, § 5.5h Disclosure Practices.
[14] Yerger, *supra* note 12, at 14.
[15] Policies, *supra* note 2, § 5.1 Introduction.

Similarly, Sec. 5 would prohibit the independent private sector Public Company Accounting Oversight Board from exercising their own expert judgment, after a thorough public due process in which the view of investors and other interested parties are solicited and carefully considered, in determining improvements to certain standards applicable to the audits of EGCs.[16]

The Council's membership "has consistently supported the view that the responsibility to promulgate accounting and auditing standards should reside with independent private sector organizations."[17] Thus, the Council opposes legislative provisions like Sec. 3(a) and Sec. 5 that override or unduly interfere with the technical decisions and judgments (including the timing of the implementation of standards) of private sector standard setters.[18]

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[16] One of the potential improvements to auditing standards referenced in Sec. 5 is "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) . . . ." We note that the Public Company Accounting Oversight Board has not yet issued a proposed rule relating to this topic. We also note that the Council, and many other investors, generally support improvements to the auditor's report that this provision would effectively defer for emerging growth companies. Letter from Jeff Mahoney to Office of the Secretary 3 (Sept. 19, 2011), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/September%2019%202011%20Letter%20to%20PCAOB.pdf.

[17] Council of Institutional Investors, Statement on Independence of Accounting and Auditing Standard Setters 1 (Adopted Oct. 7, 2008) [hereinafter Statement of Independence], http://www.cii.org/UserFiles/file/Statement%20on%20Independence%20of%20Accounting%20and%20Auditing%20Standard%20Setters.pdf.

[18] *See, e.g.,* Letter from Jeff Mahoney et el. to The Honorable Harry Reid et al. (May 7, 2010) [Joint Letter], http://www.thecaq.org/publicpolicy/pdfs/20100507StandardsetterindependencelettertoSenate.pdf (opposing "Brown amendment SA 3853 regarding 'Financial Reporting'" to the Restoring American Financial Stability Act of 2010 because of its impact on the independence of accounting standard setting); *cf.* Statement of Independence, *supra* note 17, at 2 (indicating that "technical decisions and judgments []including the timing of the implementation of standards[] [should be protected] from being overridden by government officials or bodies").

A 2010 joint letter by the Council, the American Institute of Certified Public Accountants, the Center for Audit Quality, the CFA Institute, the Financial Executives International, the Investment Company Institute, and the U.S. Chamber of Commerce[19] explains, in part, the basis for the Council's strong support for the independence of private sector standard setters:

> We believe that interim and annual audited financial statements provide investors and companies with information that is vital to making investment and business decisions. The accounting standards underlying such financial statements derive their legitimacy from the confidence that they are established, interpreted and, when necessary, modified based on independent, objective considerations that focus on the needs and demands of investors – the primary users of financial statements. We believe that in order for investors, businesses and other users to maintain this confidence, the process by which accounting standards are developed must be free – both in fact and appearance – of outside influences that inappropriately benefit any particular participant or group of participants in the financial reporting system to the detriment of investors, business and the capital markets. We believe political influences that dictate one particular outcome for an accounting standard without the benefit of public due process that considers the views of investors and other stakeholders would have adverse impacts on investor confidence and the quality of financial reporting, which are of critical importance to the successful operation of the U.S. capital markets.[20]

Internal Controls Audit

We have concerns about Sec. 4 because that provision would, in our view, unwisely expand the existing exemption for most public companies from the requirement to have effective internal controls.

More specifically, Sec. 4 would exempt an EGC from the requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX). That section requires an independent audit of a company's assessment of its internal controls as a component of its financial statement audit.

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[19] We note that the U.S. Chamber of Commerce (Chamber) has publicly opposed the comparable accounting and auditing provisions contained in the companion bill H.R. 3606, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." The Chamber indicated that they support removal of the provisions, commenting that "the opt-out for new accounting and auditing standards would create a bi-furcated financial reporting system with less certainty and comparability for investors, while creating increased liability risk for boards of directors, audit committees and Chief Financial Officers." Letter from R. Bruce Josten to The Honorable Spencer Bachus et al. 3 (Feb. 15, 2012) [hereinafter Josten], http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-2.15-HR2308_HR4014_HR3606_Bachus_Frank-3.pdf.

[20] Joint Letter, *supra* note 18, at 1.

The Council has long been a proponent of Section 404 of SOX.[21] We believe that effective internal controls are critical to ensuring investors receive reliable financial information from public companies.

We note that Section 989G(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) already exempts most public companies, including all smaller companies, from the requirements of Section 404(b).[22] We also note that Section 989G(b) of Dodd-Frank required the SEC to conduct a study on "how the Commission could reduce the burden of complying with section 404(b) . . . while maintaining investor protections . . . ."[23]

The SEC study, issued April 2011, revealed that (1) there is strong evidence that the provisions of Section 404(b) "improves the reliability of internal control disclosures and financial reporting overall and is useful to investors,"[24] and (2) that the "evidence does not suggest that granting an exemption [from Section 404(b)] . . . would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States."[25] Finally, and importantly, the study recommends explicitly against—what Sec. 4 attempts to achieve—a further expansion of the Section 404(b) exemption.[26]

Availability of Information about Emerging Growth Companies

Finally, we have concerns about Sec. 6 of S. 1933 because it appears to potentially create conflicts of interest for financial analysts.

More specifically, we agree with the U.S. Chamber of Commerce that the provisions of Sec. 6 as drafted "may be a blurring of boundaries that could create potential conflicts of interests between the research and investment components of broker-dealers."[27] The Council membership supports the provisions of Section 501 of SOX and the Global Research Analyst Settlement.[28] Those provisions bolstered the transparency, independence, oversight and accountability of research analysts.[29]

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[21] *See, e.g.,* Letter from Jeff Mahoney et al. to The Honorable Spencer Bachus et al. 1 (Nov. 29, 2011), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/CAQ-CII%20404%20letter%2011-29-11.pdf (noting that companies "that do not have an audit of management's assessment of internal controls over financial reporting tend to have both significantly more material weaknesses in their internal controls and more restatements of their financial statements").
[22] Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376, § 989G(a) (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm.
[23] *Id.* § 989G(b).
[24] Staff of the Office of the Chief Accountant of the Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002, at 112 (Apr. 2011), http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.
[25] *Id.*
[26] *Id.* ("Dodd-Frank Act already exempted approximately 60% of reporting issuers from Section 404(b), and the Staff does not recommend further extending this exemption.").
[27] Josten, *supra* note 19, at 3 (commenting on the comparable provision in the companion bill H.R. 3606, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011").
[28] Council of Institutional Investors, Statement on Financial Gatekeepers 1 (Adopted Apr. 13, 2010), http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf.
[29] *Id.* ("The Sarbanes-Oxley Act of 2002 and the 'global settlement' with Wall Street firms in 2003 bolstered the transparency, independence, oversight and accountability of . . . equity analysts.").

While the Council welcomes further examination of issues, including potential new rules, relating to research analysts as gatekeepers, it generally does not support legislative provisions like Sec. 6 that would appear to weaken the aforementioned investor protections.[30]

The Council respectfully requests that the Committee carefully consider our questions and concerns about the provisions of S. 1933. If you should have any questions or require any additional information about the Council or the contents of this letter, please feel free to contact me at 202.261.7081 or Jeff@cii.org, or Senior Analyst Laurel Leitner at 202.658.9431 or Laurel@cii.org.

Sincerely,

Jeff Mahoney
General Counsel

CC: The Honorable Jack Reed, Chairman, Subcommittee on Securities, Insurance, and Investment

The Honorable Michael D. Crapo, Ranking Member, Subcommittee on Securities, Insurance, and Investment

[30] *Id.* at 2 ("The Council welcomes further examination of financial gatekeepers by regulators, lawmakers, academics and others, to determine what changes, including new rules and stronger oversight, are needed.").