COUNCIL OF INSTITUTIONAL INVESTORS

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Via Email

August 24, 2007

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

Re: Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3 (File Number: S7-10-07)

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over $3 trillion. As a leading voice for long-term, patient capital, the Council welcomes the opportunity to provide comments on the Securities and Exchange Commission's ("SEC" or "Commission") proposal to amend the eligibility requirements of Form S-3 and Form F-3 ("Proposed Rule"). We note that Council members have about half of their domestic equity holdings invested in indexed funds,[1] including significant investments in the Russell 2000 index which contains a number of smaller public companies that would likely become eligible to use Form S-3 to access the public markets if the Proposed Rule is adopted.[2]

Overall, we generally support the Proposed Rule and its underlying purpose of allowing "more companies to benefit from the greater flexibility and efficiency in accessing the public securities markets afforded by Forms S-3 and F-3 without compromising investor protection."[3] We, however, believe that the following revisions to the Proposed Rule are necessary to ensure that the final rule will adequately protect and serve the needs of investors.

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[1] Council of Institutional Investors ("Council"), *Pension Fund Performance Survey* 9 (Aug. 23, 2004).

[2] *See* Russell 2000® Index, Fact Sheet (July. 31, 2007), *available at* http://www.russell.com/indexes/PDF/Fact_Sheets/2000.pdf.

[3] Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 And F-4, Securities Act Release No. 8,812, 72 Fed. Reg. 35,118, 35,118 (proposed June 26, 2007).

Risks to Investor Protection

We share the Commission's concerns that the Proposed Rule presents "risks to investor protection by expanding the base of companies eligible for primary offerings" on Forms S-3 and F-3.[4] We agree with the Commission that those risks include:

- "[A]llowing smaller public companies . . . to avail themselves of periodic takedowns [of securities] without further Commission action or prior staff review . . . ."[5]
- "'[E]xpedited access to the markets that would be provided . . . could make it difficult for gatekeepers, particularly underwriters, to perform adequate due diligence for the smaller companies . . . .'"[6]
- "[C]ompanies with a smaller market capitalization as a group have a comparatively smaller market following than larger, well-seasoned issuers and are more thinly traded . . . [and, therefore,] may be more vulnerable to potential manipulative practices."[7]

In addition to the above risks, we believe that the final rule should explicitly acknowledge that smaller public companies have long been especially prone to financial reporting fraud.[8] Consistent with the historical evidence, a recent analysis of the reporting by public companies in response to SEC Staff Accounting Bulletin No. 108 found that (1) reporting errors at smaller public companies "***tend to be more significant***" than those of larger companies;[9] and (2) smaller public companies "are more likely to sit on errors that decrease earnings than big companies."[10] Thus, the Commission should ensure that the final rule avoids understating the significant risks that smaller public companies present to investors.

Limitations on eligibility

As a result of the significant risks to investors that result from expanding the base of companies eligible for primary offerings under Forms S-3 and F-4, we generally support the Proposed Rule limitations that (1) exclude shell companies and companies that were recently shell companies from eligibility; (2) impose a twenty percent restriction on the amount of securities that can be sold over any period of twelve calendar months; and (3) require that other existing registrant eligibility conditions for the use of the Form S-3 or F-3 be met.[11] Moreover, we would oppose any weakening of the proposed limitations on eligibility in the final rule.

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[4] *Id.* at 35,124.
[5] *Id.* at 35,123-24.
[6] *Id.* at 35,123 n. 45.
[7] *Id.* at 35,124.
[8] *See, e.g.*, Carlo di Floria, *COSO Study on Fraud in Financial Reporting* 4 (Oct. 1999) ("In the past decade, most fraud in financial reporting among public companies was committed by smaller corporations, with well below $100 million in assets."), *available at* http://www.transparency.org/iacc/9th_iacc/papers/day3/ws7/d3ws7_cdflorio.html.
[9] Jack T. Ciesielski, *Out of Sight, Out of Mind: Staff Accounting Bulletin 108*, 16 Analyst's Acct. Observer 9 (Apr. 16, 2007).
[10] *Id.* at 8.
[11] 72 Fed. Reg. at 35,120, 35,125.

Section 404

In addition, the Council agrees with the Commission that in order to avoid "adversely impacting investors" smaller public companies should only be eligible for primary offerings under Forms S-3 and F-4 if they have "sufficiently comparable" disclosure obligations and liability under the federal securities laws consistent with that of "the largest reporting companies."[12] We note that footnote forty-six suggests that "sufficiently comparable" includes the implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX").[13]

The Council believes that the internal control requirements of Section 404 are a core element of SOX and play a vital role in ensuring high quality financial reporting and in maintaining investor confidence in the markets. Consistent with the requirements of Section 404, we believe any company tapping the public markets to raise capital, particularly the generally riskier smaller public companies that are the subject of the Proposed Rule, should have appropriate internal controls in place with meaningful review by external auditors.

The Council observes that implementation of Section 404 is substantially improving companies' internal controls and the quality of their financial reporting. A recent report analyzing Section 404 filings concludes:

> As the first significant wave of third year Section 404 filings begins to ebb, one thing should be clear: the quality and reliability of public company financial statement reporting has improved dramatically under SOX directives. Based on the results of the first 3,000 third year Section 404 filers (out of approximately 4,500 that will file throughout the entire year), the adverse Section 404 opinion rates have dropped precipitously. As of filings through April 1st, the year 3 adverse opinion rate had dropped to 5.4%, down from 10.5% in year 2 and 16.9% in year 1. . . .
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> In short, companies . . . have benefited from the requirements of Sarbanes Oxley and more specifically Section 404. Financial statements . . . have been materially improved. One could claim that every investor, big or small, has benefited from the elimination of substantial deficiencies in registrant financial reporting.[14]

[12] *Id.* at 35,124.
[13] *Id.* at n. 46.
[14] Audit Analytics, Second Year 404 Dashboard With Updates for Year Three 1 (Apr. 2007) (footnotes omitted), *available at* http://www.auditanalytics.com/doc/report-ic-2007-04.pdf.

We note that in December 2006 the Commission deferred the implementation of Section 404 for non-accelerated filers (public companies with less than $75 million in market cap) for the fourth time and established the following two-phased effective date: (1) the management report on internal control over financial reporting is required to first be provided when the company files its annual report for its fiscal year ending on or after December 15, 2007; and (2) the auditor's attestation report on internal control over financial reporting is required to first be provided when the company files its annual report for its first fiscal year ending on or after December 15, 2008.[15] We also note that in June 2007 the House of Representatives voted in favor of an amendment to the Financial Services Appropriations Act of 2008 that, if enacted, would further delay the implementation of Section 404 for non-accelerated filers for "another eight months."[16]

As indicated above, the Council believes that the implementation of Section 404 is essential to investor protection. The final rule, therefore, should make explicit that *only* those public companies that have *fully* implemented the management *and* auditor attestation report requirements of Section 404, and have met the other requirements of the final rule, are eligible for accessing the public securities markets through the use of Forms S-3 and Form F-3.

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The Council appreciates the opportunity to provide our comments on the Proposed Rule. Please feel free to contact me with any questions.

Sincerely,

Jeff Mahoney
General Counsel

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[15] Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Securities Act Release No. 8,760, Exchange Act Release No. 54,942, 71 Fed. Reg. 76,580 (Dec. 21, 2006).

[16] Press Release, Representative Tom Feeney, Looking Out for the Little Guy *Feeney-Garrett Amendment Passes to Help Keep American Small Business Competitive* (June 28, 2007), *available at* http://www.house.gov/list/press/fl24_feeney/garrettfeeney.shtml. Of note, the Council strongly opposes any further deferral of the internal control requirements of Section 404 for smaller public companies. *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable José E. Serrano and the Honorable Ralph Regula, Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives 4 (June 27, 2007), *available at* http://www.cii.org/library/correspondence/06-27-07%20-Serrano.pdf.