

FOSTERING INNOVATION ACT OF 2017

NOVEMBER 28, 2017.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services,  
submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany H.R. 1645]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 1645) to amend the Sarbanes-Oxley Act of 2002 to provide a temporary exemption for low-revenue issuers from certain auditor attestation requirements, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE AND SUMMARY

On March 21, 2017, Representatives Kyrsten Sinema and Trey Hollingsworth introduced H.R. 1645, the “Fostering Innovation Act of 2017”, which amends Section 404(b) of the Sarbanes-Oxley Act (SOX) to extend the exemption available to emerging growth companies (EGCs) from the auditor attestation of a company’s internal controls over financial reporting requirement beyond the five-year period that applies under current law. Specifically, the bill extends the exemption until the earlier of ten years after the EGC went public, the end of the fiscal year in which the EGC’s average gross revenues exceed \$50 million, or when the EGC qualifies with the Securities and Exchange Commission (SEC) as a large accelerated filer, \$700 million public float, which is the number of shares available to trade freely between investors that are not controlled by corporate officers or promoters.

## BACKGROUND AND NEED FOR LEGISLATION

The goal of H.R. 1645 is to extend the exemption status for EGCs from SOX 404(b) requirements beyond the initial five year period under current law. The legislation does not relieve an EGC from its responsibilities under SOX 404(a), which require that management establish and maintain an adequate internal control structure and procedures for financial reporting.

Title I of the Jumpstart Our Business Startups (JOBS) Act established EGCs as a new category of issuers. These issuers have less than \$1 billion in annual revenues or \$700 million in public float when they register with the SEC and are given up to five years—known as an “on ramp”—to comply with certain regulatory requirements, including SOX Section 404(b). By granting these issuers temporary “on ramp” status, Title I encourages small companies to go public while ensuring that they move to full compliance with regulatory requirements as they become large enough to support the legal, accounting, and compliance infrastructure more typical of mature enterprises.

Pursuant to SOX Section 404, the management of a public company must assess the effectiveness of the company’s internal controls over financial reporting. A key driver of SOX compliance costs is Section 404(b), which requires a public company’s auditor to attest to, and report on, management’s assessment of the company’s internal controls. Studies of compliance costs overwhelmingly indicate that Section 404 has increased public companies’ accounting and auditing expenditures, regardless of company size.

In fact, the costs to comply with Section 404(b) have far exceeded the SEC’s original estimates. A 2008 report by the Heritage Foundation stated that while the SEC initially estimated the cost of complying with Section 404 to be \$1.24 billion in the aggregate, multiple studies have projected the actual cost to be \$35 billion, almost 30 times that of the original estimate. Moreover, these costs impact small accelerated filers disproportionately when compared with large accelerated filers. CRA International’s survey data indicates that for a small accelerated filer—which includes companies with market capitalization between \$75 million and \$700 million—the total year-one Section 404 implementation cost per company is \$1.5 million, or 0.46 percent of revenue. For a large accelerated filer—which is a company with market capitalization above \$700 million—the total is \$7.3 million, or 0.09 percent of its revenue.

Similarly, in 2010, the Independent Community Bankers Association (ICBA) concluded that:

while [Section] 404 auditor costs declined 5.4% from 2006 as the auditor scope of work narrowed, these costs were offset by a reported [5%] increase in the average hourly audit rate charged by auditors. [Financial Executives International] also found that auditor attestation fees paid by accelerated filers in 2007 constituted 23.7% of the accelerated filer’s total annual audit fees and averaged \$846,000, representing only a 5.4% decrease from 2006. In September 2009, the SEC’s Office of Economic Analysis issued its 140 page report on the costs of complying with SOX 404 . . . [and] found that for companies that were already complying with Section 404(b), the mean total Sec-

tion 404 compliance cost following the issuance of the SEC guidance was still a staggering \$2.33 million per year. Section 404(b) audit fees were a significant portion of those total costs, amounting to a mean average of \$1,127,325. . . . [T]he Study showed that for filers with public float lower than \$75 million, the mean SOX 404 compliance cost following the issuance of SEC guidance was very high \$690,000 per year and the mean 404(b) audit cost was \$259,004. From its Study, the SEC generally concluded that smaller publicly held companies have higher SOX 404 compliance costs as a fraction of their asset value [than larger reporting companies].

A May 2014 survey conducted by compliance and audit consultant Protiviti similarly found that around 53% of large organizations currently spend \$1 million or more on SOX compliance, and 30% spend \$2 million or more annually. The Protiviti survey concluded that “SOX compliance costs are rising more sharply than in the past,” partly as a result of recent Public Company Accounting Oversight Board (PCAOB) inspections of external auditing firms, which indicated that “external auditors were not doing enough work and thus needed to invest more time in [SOX Section 404] audits.”

The significant burdens associated with SOX Section 404(b) compliance disproportionately affect smaller public companies, divert resources from growth to regulatory costs, and harm the ability of these firms to compete against larger peers and foreign competitors. According to Heritage, “Section 404 compliance cost constitutes a substantial fixed cost component that imposes a disproportionate burden on smaller public companies as they are inherently unable to spread the cost with the economies of scale.” Heritage found that “in the first compliance year, the median audit fee as a percentage of revenue for companies with a market cap of less than \$75 million and between \$75 million and \$250 million was 0.75 percent and 0.48 percent, respectively. In contrast, that for companies with a market cap of more than \$5 billion was 0.07 percent.”

Increased compliance costs also serve as a disincentive for smaller companies to become and remain public companies. For example, ICBA pointed out:

[W]ith more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies are disproportionately impacted by the burdens associated with Section 404 compliance . . . . [T]he benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, who rely to a greater degree on ‘tone at the top’ and high-level monitoring controls, to influence accurate financial reporting. . . . [T]he proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts

their capital formation ability and, as a result, hurts the U.S. economy.

In its report on Capital Markets mandated by President Trump's February 3, 2017 Executive Order, the Department of Treasury recommended an increase in the length of time a company may maintain its EGC status for up to 10 years, subject to a revenue and/or public float threshold, in order to more appropriately tailor compliance costs associated for a smaller public company.

#### HEARINGS

The Committee on Financial Services and the Subcommittee on Capital Markets, Securities, and Investment held a hearing examining matters relating to H.R. 1645 on March 22, 2017, April 26, 2017, April 28, 2017, and July 18, 2017.

#### COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on October 11, 2017, October 12, 2017, and ordered H.R. 1645 to be reported favorably to the House without amendment by a recorded vote of 48 yeas to 12 nays (Record vote no. FC-91), a quorum being present.

#### COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. The sole recorded vote was on a motion by Chairman Hensarling to report the bill favorably to the without amendment. The motion was agreed to by a recorded vote of 48 yeas to 12 nays (Record vote no. FC-91), a quorum being present.

## Record vote no. FC-91

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling .....	X			Ms. Maxine Waters (CA) .....		X	
Mr. McHenry .....	X			Mrs. Carolyn B. Maloney (NY) ..	X		
Mr. King .....	X			Ms. Velázquez .....	X		
Mr. Royce (CA) .....	X			Mr. Sherman .....		X	
Mr. Lucas .....	X			Mr. Meeks .....	X		
Mr. Pearce .....	X			Mr. Capuano .....		X	
Mr. Posey .....	X			Mr. Clay .....		X	
Mr. Luetkemeyer .....	X			Mr. Lynch .....		X	
Mr. Huizenga .....	X			Mr. David Scott (GA) .....	X		
Mr. Duffy .....	X			Mr. Al Green (TX) .....		X	
Mr. Stivers .....	X			Mr. Cleaver .....		X	
Mr. Hultgren .....	X			Ms. Moore .....		X	
Mr. Ross .....	X			Mr. Ellison .....		X	
Mr. Pittenger .....	X			Mr. Perlmutter .....		X	
Mrs. Wagner .....	X			Mr. Himes .....		X	
Mr. Barr .....	X			Mr. Foster .....	X		
Mr. Rothfus .....	X			Mr. Kildee .....	X		
Mr. Messer .....	X			Mr. Delaney .....	X		
Mr. Tipton .....	X			Ms. Sinema .....	X		
Mr. Williams .....	X			Mrs. Beatty .....		X	
Mr. Poliquin .....	X			Mr. Heck .....	X		
Mrs. Love .....	X			Mr. Vargas .....	X		
Mr. Hill .....	X			Mr. Gottheimer .....	X		
Mr. Emmer .....	X			Mr. Gonzalez (TX) .....	X		
Mr. Zeldin .....	X			Mr. Crist .....	X		
Mr. Trott .....	X			Mr. Kihuen .....	X		
Mr. Loudermilk .....	X						
Mr. Mooney (WV) .....	X						
Mr. MacArthur .....	X						
Mr. Davidson .....	X						
Mr. Budd .....	X						
Mr. Kustoff (TN) .....	X						
Ms. Tenney .....	X						
Mr. Hollingsworth .....	X						

## COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

## PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 1645 will reduce regulatory compliance costs for EGCs by extending the exemption to comply with Section 404(b) of the Sarbanes-Oxley Act.

## NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

## CONGRESSIONAL BUDGET OFFICE ESTIMATES

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,  
CONGRESSIONAL BUDGET OFFICE,  
*Washington, DC, November 1, 2017.*

Hon. JEB HENSARLING,  
*Chairman, Committee on Financial Services,  
House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 1645, the Fostering Innovation Act of 2017.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Stephen Rabent.

Sincerely,

KEITH HALL,  
*Director.*

Enclosure.

*H.R. 1645—Fostering Innovation Act of 2017*

Under current law, the Securities and Exchange Commission (SEC) requires issuers of securities to file assessments of their internal control structures and procedures for financial reporting and have those reports be attested to and covered in an audit report. The Jumpstart Our Business Startups Act of 2012 exempted companies with annual revenue and debt issuance under specified thresholds from the requirement to have an auditor's attestation as part of their internal control reports for up to 5 years after their

first sale of equity securities. H.R. 1645 would increase that maximum exemption period to 10 years.

Based on an analysis of information from the SEC, CBO estimates that implementing H.R. 1645 would have no significant effect on the agency's costs because the SEC would not have to update agency rules to implement the bill. Moreover, the SEC is authorized to collect fees sufficient to offset its annual appropriation; therefore, assuming appropriation actions consistent with that authority, CBO estimates that the net effect on discretionary spending would be negligible.

Enacting H.R. 1645 would not affect direct spending or revenues; therefore, pay-as-you-go procedures do not apply.

CBO estimates that enacting H.R. 1645 would not increase net direct spending or on-budget deficits in any of the four consecutive 10-year periods beginning in 2028.

H.R. 1645 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act.

The CBO staff contact for this estimate is Stephen Rabent. The estimate was approved by H. Samuel Papenfuss, Deputy Assistant Director for Budget Analysis.

#### FEDERAL MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

#### ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

#### APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

#### EARMARK IDENTIFICATION

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

#### DUPLICATION OF FEDERAL PROGRAMS

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public

Law 111–139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95–220, as amended by Pub. L. No. 98–169).

#### DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rulemakings: The Committee estimates that the bill requires no directed rulemakings within the meaning of such section.

#### SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

##### *Section 1. Short title*

This Section cites H.R. 1645 as the “Fostering Innovation Act of 2017”

##### *Section 2. Temporary exemption for low-revenue issuers*

This section amends Section 404 of the Sarbanes-Oxley Act of 2002 to extend the exemption from 404(b) compliance for EGCs until the earlier of ten years after the company went public, the end of the fiscal year in which the EGC’s average gross revenues exceed \$50 million, or when the EGC becomes a large accelerated filer—at least \$700 million public float—with the SEC.

#### CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, and existing law in which no change is proposed is shown in roman):

#### CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

### **SARBANES-OXLEY ACT OF 2002**

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## **TITLE IV—ENHANCED FINANCIAL DISCLOSURES**

\* \* \* \* \*

#### **SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.**

(a) **RULES REQUIRED.**—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer, other than an issuer that is an emerging growth company (as defined in section 3 of the Securities Exchange Act of 1934), shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

(c) EXEMPTION FOR SMALLER ISSUERS.—Subsection (b) shall not apply with respect to any audit report prepared for an issuer that is neither a “large accelerated filer” nor an “accelerated filer” as those terms are defined in Rule 12b–2 of the Commission (17 C.F.R. 240.12b–2).

(d) TEMPORARY EXEMPTION FOR LOW-REVENUE ISSUERS.—

(1) LOW-REVENUE EXEMPTION.—Subsection (b) shall not apply with respect to an audit report prepared for an issuer that—

(A) ceased to be an emerging growth company on the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act of 1933;

(B) had average annual gross revenues of less than \$50,000,000 as of its most recently completed fiscal year; and

(C) is not a large accelerated filer.

(2) EXPIRATION OF TEMPORARY EXEMPTION.—An issuer ceases to be eligible for the exemption described under paragraph (1) at the earliest of—

(A) the last day of the fiscal year of the issuer following the tenth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act of 1933;

(B) the last day of the fiscal year of the issuer during which the average annual gross revenues of the issuer exceed \$50,000,000; or

(C) the date on which the issuer becomes a large accelerated filer.

(3) DEFINITIONS.—For purposes of this subsection:

(A) AVERAGE ANNUAL GROSS REVENUES.—The term “average annual gross revenues” means the total gross revenues of an issuer over its most recently completed three fiscal years divided by three.

(B) EMERGING GROWTH COMPANY.—The term “emerging growth company” has the meaning given such term under section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c).

*(C) LARGE ACCELERATED FILER.—The term “large accelerated filer” has the meaning given that term under section 240.12b–2 of title 17, Code of Federal Regulations, or any successor thereto.*

\* \* \* \* \*

## MINORITY VIEWS

H.R. 1645 would amend the Sarbanes-Oxley Act of 2002 (SOX) to exempt certain companies from Section 404(b) audit requirements for up to a decade if they have average annual gross revenues of less than \$50 million and a public float of less than \$700 million.

Congress enacted SOX fifteen years ago in the wake of Enron and several other high-profile corporate and accounting scandals that collectively cost investors billions of dollars and undermined confidence in U.S. capital markets. SOX protects investors from similar misconduct by increasing the accuracy and transparency of financial reporting by public companies. Specifically, Section 404(b) requires an external auditor to attest to and report on management's assessment of the company's internal controls over financial reporting. H.R. 1645 would create an unnecessary and harmful exemption from these important requirements.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203) already provides a permanent exemption from Section 404(b) for any company with a public float of less than \$75 million (i.e., companies that are not classified "as accelerated filers" or "large accelerated filers"). This exemption currently applies to fully half of all public companies.

Additionally, the Jumpstart Our Business Startups (JOBS) Act of 2012 (P.L. 112-106) created a five-year exemption from Section 404(b) for companies that go public with less than \$1 billion in annual revenues, referred to as "Emerging Growth Companies" (EGCs). Since the enactment of the JOBS Act, 85% of companies that have gone public have done so as EGCs.

The JOBS Act ensures that large companies adhere to the SOX 404(b) auditor requirements by terminating EGC status (and the associated exemption) after a company has been public for five years; or when the company has a public float of more than \$700 million, annual revenues exceeding \$1.07 billion, or debt issuance exceeding \$1.07 billion.

H.R. 1645 would further delay compliance for up to a decade for companies that no longer qualify as EGCs. This new exemption is unnecessary in light of existing exemptions and could prove harmful to the companies that H.R. 1645 purports to help. In 2013, a Government Accountability Office (GAO) report found that companies that do not undergo an audit of their internal controls over financial reporting have a significantly higher likelihood of restating their financial statements. Financial restatements are major reporting errors that can damage a public company's reputation and reduce investor confidence in the company, its management, and the broader capital markets.

Removing Section 404(b) requirements can also harm investors, who rely on corporate financial statements when making invest-

ment decisions. For this reason, academics, investor advocates, and regulators have opposed expanding SOX 404(b) exemptions. For example, Rick Fleming, the Securities and Exchange Commission's Investor Advocate, opposed an identical bill last Congress on the grounds that expanding 404(b) exemptions to a new class of issuers would "weaken[] an important investor protection" and "further compound[] the complexity of securities law reporting requirements . . . ." Professor Robert Brown of the University of Denver, Sturm College of Law has also advised against expanding exemptions to SOX 404(b) requirements. During a July 18, 2017, hearing of the Capital Markets Subcommittee, Professor Brown testified that, as a matter of "human nature, if you are inside a company, and you are responsible for internal controls, if you know somebody from the outside is going to come and look at them, you are going to do a better job." Investor advocacy groups including Americans for Financial Reform, Center for American Progress, Consumer Federation of American, and Public Citizen have also opposed H.R. 1645 on the basis that increasing exemptions from SOX 404(b) would endanger investors and diminish the integrity of U.S. capital markets.

In short, SOX 404(b) auditor requirements provide substantial benefits to investors and companies. These requirements promote investor confidence in U.S. capital markets, strengthen internal controls, and help prevent fraud. For these reasons, we oppose H.R. 1645.

MAXINE WATERS.  
KEITH ELLISON.  
MICHAEL E. CAPUANO.  
JOYCE BEATTY.  
EMANUEL CLEAVER.  
WM. LACY CLAY.  
AL GREEN.  
STEPHEN F. LYNCH.

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