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SEC Amends ‘Accelerated Filer’ Definition to Exempt Low-Revenue Smaller Reporting Companies From SOX 404(b)

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On March 12, the SEC voted (by a vote of three to one, with Commissioner Allison Lee dissenting) to **approve amendments** to the "accelerated filer" and "large accelerated filer" definitions to provide a narrow carve-out for companies that qualify as "smaller reporting companies" (SRCs) *and* reported less than $100 million in annual revenues in the most recent fiscal year for which audited financial statements were available. Most significantly, under the amendments, companies qualifying for the carve-out will no longer be subject to the SOX 404(b) requirement to have an auditor attestation report on internal control over financial reporting (ICFR), a requirement that applies to accelerated and large accelerated filers. The amendments will become effective on April 27.

In adopting these amendments, **the SEC said** that the amendments will "more appropriately tailor the types of issuers that are included in the definitions, thereby reducing unnecessary burdens and compliance costs for certain smaller issuers while maintaining investor protections. The amendments are consistent with the Commission's and Congress's historical practice of providing scaled disclosure and other accommodations to reduce unnecessary burdens for new and smaller issuers."

The issue of whether – and how – to address the accelerated filer definition has been steeped in controversy for several years. But not, as the designation accelerated filer might suggest, because a revision of the definition would allow a new tranche of companies to prepare and file their periodic reports on a more relaxed schedule; that result has been largely disregarded as inconsequential. Rather, the controversy arises out of the potential exemption of these additional companies from the obligation to obtain a SOX 404(b) auditor attestation on ICFR, a requirement that is viewed as critical investor protection by its advocates, but is anathema to many supporters of deregulation.

Background

In June 2018, **the SEC approved amendments** that raised the cap for status as a smaller reporting company from less than $75 million in public float to less than $250 million. Those amendments also designated as SRCs companies with less than $100 million in annual revenues if they also had either no public float or a public float of less than $700 million. These changes, however, disturbed the previous alignment between the categories of "smaller reporting company" and "non-accelerated filer," with the result that some companies have been categorized as both SRCs and accelerated filers (or, surprisingly, even large accelerated filers). Many commenters at the time took the opportunity to recommend that the SEC increase the public float threshold in the accelerated filer definition to be commensurate with the cap in the new SRC definition, arguing that the costs associated with SOX 404(b) were burdensome and "divert capital from core business needs."

Although the SEC elected not to raise the accelerated filer threshold at that time, notwithstanding the admitted additional regulatory complexity, SEC Chair Jay Clayton did direct the staff to formulate recommendations "for possible additional changes to the 'accelerated filer' definition that, if adopted, would have the effect of reducing the number of companies that qualify as accelerated filers in order to promote capital formation by reducing compliance costs for those companies, while maintaining appropriate investor protections." As a result, it was widely expected that the SEC would harmonize these filer categories and simply propose to raise the threshold for accelerated filer status to align with the SRC cap, as had been recommended by various advisory groups.

But the SEC opted for a narrowly tailored carve-out that attempts to thread the needle with regard to the SOX 404(b) controversy, an approach the SEC viewed as analogous to other past approaches that opted for scaled disclosure. However, the resulting framework for determining filer categories and requirements adds another layer of complexity to the current labyrinth, including some rather head-spinning new transition provisions. Notably, commenters have been predictably split, expressing mixed views on the effect of the new amendments on capital formation, decisions to go public and the effect on investor protection. That mix of views was also largely reflected in the opinions of the SEC commissioners.

Current rules

Currently, under Rule 12b-2, to be an accelerated filer, a company must have:

- An aggregate worldwide public float of $75 million or more, but less than $700 million, as of the last business day of the company's most recently completed second fiscal quarter;
- Been subject to the Exchange Act reporting requirements for at least 12 calendar months; and
- Filed at least one annual report.

A large accelerated filer must have an aggregate worldwide public float of $700 million or more, as of the last business day of its most recently completed second fiscal quarter, and also satisfy the second and third conditions above.

Under the current rules, an accelerated filer can also be an SRC if it has a public float of $75 million or more, but less than $250 million, regardless of annual revenues; or a public float of more than $250 million, but less than $100 million in annual revenues. The new amendments primarily benefit those SRCs with public floats between $75 million and $250 million, which previously would have been accelerated filers regardless of how little revenue they had, but now will avoid accelerated filer status if they have less than $100 million in annual revenues.

Changes to the accelerated filer definition

Under SOX 404(c), companies that are neither large accelerated filers nor accelerated filers are exempt from the auditor attestation requirement for ICFR. The new amendments exclude from the definitions of accelerated filer and large accelerated filer in Rule 12b-2 any issuer that is eligible to be an SRC *and* had annual revenues of less than $100 million in the most recent fiscal year for which audited financial statements are available. More specifically, the new amendments add a new fourth condition to the definitions of accelerated and large accelerated filer: that the company not be eligible to be an SRC under the revenue test (in paragraphs (2) or (3)(iii)(B), as applicable) of the smaller reporting company definition in Rule 12b-2. (By referring to the paragraphs, the SEC intended to add flexibility in the event the thresholds change in the future.) Although not addressed in this alert, the new amendments also exclude business development companies from the definitions under similar circumstances.

It is worth noting that emerging growth companies (EGCs) are exempt from the auditor attestation requirement of SOX 404(c) regardless of their filing status. Nothing in the new amendments changes that.

SEC rationale for the amendments

The SEC generally believes that including certain low-revenue issuers in the accelerated and large accelerated filer definitions may involve greater costs and relatively lower benefits, as compared to other issuers, largely because "low-revenue issuers may, on average, be less susceptible to the risk of certain types of restatements, such as those related to revenue recognition."

With regard to costs, the SEC estimates that a company that is no longer subject to the SOX 404(b) requirement would save approximately $210,000 a year, which the SEC viewed as a "meaningful cost savings for many of the affected issuers." The SEC believes that the costs of the attestation requirement may be disproportionately burdensome for low-revenue SRCs because they "include fixed costs that are not scalable for smaller issuers." According to the SEC, the cost reduction could be a positive factor that could encourage more companies to go public. The SEC observed that, over the last 20 years, the number of public companies listed on major exchanges has decreased by about 40%, but the decline has been concentrated among smaller companies, those with market caps below $700 million (65% decline) and those with revenues under $100 million (60% decline). Reducing the costs and burdens of public company status could reverse that trend.

Finally, in the case of low-revenue companies, the SEC suggests that the benefit of the ICFR auditor attestation may not live up to its advertising. In light of the other protections available, such as the management assessment of ICFR, the aspects of ICFR review that are included in financial statement audits, and the auditors' requirement to communicate significant deficiencies and material weaknesses in ICFR to management and others, the SEC believes that "the amendments are not likely to have a significant effect on the overall ability of investors in the affected issuers to make informed investment decisions."

Although the SEC acknowledges that the amendments "may be associated with some adverse effects on the effectiveness of ICFR and the reliability of financial statements for the affected issuers," the SEC points to "evidence that suggests that these effects and their impact on investor protection are likely to be mitigated in the case of the affected issuers as compared to other accelerated filers." According to the SEC, there are probably fewer benefits of the attestation for low-revenue SRCs than for other issuers. The economic analysis indicated that 10% to 20% of restatements and about 60% of financial disclosure fraud cases relate to improper revenue recognition, a problem to which low-revenue SRCs may be less susceptible. In addition, low-revenue companies have, on average, the SEC maintained, restatement rates "three to nine percentage points lower than those for higher-revenue issuers. Moreover, certain low-revenue SRCs likely have less complex financial systems and controls and, therefore, may be less likely than other issuers to fail to detect and disclose material weaknesses in the absence of an ICFR auditor attestation." Finally, the SEC believes that the financial statements of low-revenue SRCS "may be less critical to assessing their valuation" relative to "their future prospects."

Relationships among the categories of filers

Although many were hoping for complete alignment of the SRC and non-accelerated filer categories, the SEC elected not to take that leap, in the belief that it would have resulted in greater costs and risks of adverse impact on the reliability of the financial statements of higher-revenue companies. The SEC's table below illustrates the relationships among the filer categories under the new amendments:

Relationships between SRCs and non-accelerated and accelerated filers under the new amendments

Public Status	Revenues
SRC and non-accelerated filer	Less than $75 million
SRC and non-accelerated filer	$75 million to less than $100 million
SRC and accelerated filer	Less than $250 million
Accelerated filer (not an SRC)	$250 million to less than $700 million
Large accelerated filer (not an SRC)	$700 million or more

Effect of the new amendments

As noted above, a company subject to the carve-out, in addition to being exempt from obtaining an auditor attestation and report on management's assessment of ICFR, will no longer be required to file its periodic reports in accordance with the accelerated filer time frames, nor will it have to provide disclosure regarding unresolved staff comments on periodic reports or whether it made its filings available on its website. Because the SEC elected to pursue a more tailored approach that distinguishes among SRCs, companies with public floats between $75 million and $250 million will still be subject to all of the accelerated filer requirements *unless* their revenues are under the $100 million revenue cap.

The amendments will also add a check box to the cover pages of annual reports on Forms 10-K, 20-F, and 40-F to indicate whether an ICFR auditor attestation is included in the filing. As required under inline XBRL, companies will also be required to tag this cover page check box. Commissioner Hester Peirce remarked that the new check box will make it easy for investors to decide whether they want to invest in companies that have chosen not to devote resources to internal controls audits.

A foreign private issuer (FPI) is not qualified for status as an SRC or to comply with the requirements for SRCs unless it elects to use the forms and rules designated for domestic issuers and provides financial statements prepared in accordance with U.S. GAAP. But an FPI that does qualify as an SRC under the $100 million revenue test would be excluded from the accelerated and large accelerated filer definitions.

Revisions to the transition provisions under the new amendments

The new amendments also revise the transition provisions applicable to companies exiting accelerated and large accelerated filer status. This structure is designed to avoid situations in which companies enter and exit non-accelerated filer status due to small fluctuations in their public float or revenues.

Under current rules, an accelerated filer will lose that status and become a non-accelerated filer if it determines at the end of a fiscal year that its public float had fallen below $50 million on the last business day of its most recently completed second fiscal quarter. Similarly, a large accelerated filer will lose that status if its public float had fallen below $500 million on the same date, becoming an accelerated filer if its public float was $50 million or more, and a non-accelerated filer if its public float had fallen below $50 million.

To align the SRC, accelerated filer and large accelerated filer transition thresholds, the new amendments increase from $50 million to $60 million the public float transition thresholds for accelerated and large accelerated filers to become non-accelerated filers and increase the threshold for exiting large accelerated filer status from $500 million to $560 million. These new public float transition thresholds represent 80% of the corresponding initial thresholds, consistent with the approach taken for the transition thresholds for SRC eligibility.

The SEC's table below shows these changes:

New amendments to the public float transition thresholds

Subsequent Annual Public Float Determination	Initial Public Float	Resulting Filer Status
$700 million or more	$700 million or more	Large Accelerated Filer
Less than $700 million but $560 million or more	$700 million or more	Accelerated Filer
$700 million or more	Less than $700 million but $560 million or more	Accelerated Filer
Less than $700 million but $560 million or more	Less than $700 million but $560 million or more	Accelerated Filer
Less than $560 million	Less than $700 million but $560 million or more	Non-Accelerated Filer
Less than $700 million but $560 million or more	Less than $560 million	Non-Accelerated Filer
Less than $560 million	Less than $560 million	Non-Accelerated Filer

In addition, the new amendments add more complexity with a new revenue test as part of the transition thresholds for exiting both accelerated and large accelerated filer status. As amended, a company that is already an accelerated filer will remain an accelerated filer unless either its public float falls below $60 million or it becomes eligible to be an SRC under the revenue test in paragraphs (2) or (3)(iii)(B), as applicable, of the SRC definition.

Note that paragraph (2) of the SRC definition states that a company qualifies as an SRC if its annual revenues are less than $100 million and it has no public float or a public float of less than $700 million. Paragraph (3)(iii)(B) states, among other things, that a company that initially determines it does not qualify as an SRC because it had annual revenues of $100 million or more cannot become an SRC until its annual revenues fall below $80 million. A company that is initially applying the SRC definition or previously qualified as an SRC would apply paragraph (2) of the SRC definition. Once the company determines that it does not qualify for SRC status, it would apply paragraph (3)(iii)(B) of the SRC definition at its next annual determination.

In essence, as the proposing release explained, under the amendments, "an accelerated filer would remain an accelerated filer until its public float falls below $60 million or its annual revenues fall below the applicable revenue threshold ($80 million or $100 million), at which point it would become a non-accelerated filer."

Similarly, a large accelerated filer would become an accelerated filer at the end of its fiscal year if its public float fell to $60 million or more, but less than $560 million, as of the last business day of its most recently completed second fiscal quarter and its annual revenues were not below the applicable SRC revenue threshold ($80 million or $100 million). A large accelerated filer would become a non-accelerated filer if its public float fell below $60 million as of the last business day of its most recently completed second fiscal quarter or its annual revenues fell below the applicable revenue threshold ($80 million or $100 million).

Transition

The new amendments will become effective on April 27 (30 days after publication in the Federal Register) and will apply to annual reports due on or after the effective date. Accordingly, even if the annual report is for a fiscal year ending *before* the effective date, the company may determine its status as a non-accelerated, accelerated or large accelerated filer based on the amendments (e.g., a March 31 FYE company with a 10-K due after the effective date may apply the amendments to determine its filing status even though its FYE precedes the effective date; if it determines it is eligible to be a non-accelerated filer, it will not be required to provide an ICFR auditor attestation for its annual report due and submitted after the effective date and may comply with the more relaxed filing deadlines and other accommodations for non-accelerated filers. However, a company with a fiscal year that ended on December 31, 2019 will retain its current filer status until the end of 2020, and will reflect any change in status on its Form 10-K to be filed in 2021. In the meantime, it will check the same status boxes on its first quarter Form 10-Q as it did on its most recent Form 10-K.

Observations and commentary

- In his statement, **SEC Chair Clayton contended** that Congress's retrospective review of SOX in the JOBS Act, which exempted emerging growth companies for five years, has proven to be correct over time: "Providing up to a five-year on-ramp that included an exemption from Section 404(b) for EGCs to join the public markets incentivized more companies to join our public markets and provided public market investors with more investment opportunities. And, importantly, investors have made it clear that this…approach is appropriate."

  Clayton viewed the new amendments as "a much needed recalibration of three categories of reporting companies – smaller reporting company, accelerated filer and large accelerated filer." Considering the amendments with a broader perspective allowed him to "enthusiastically support" adoption. First, he argued, Congress had already determined that smaller issuers and EGCs should be exempt from SOX 404(b) and, as noted above, that approach had already proven to be correct. The amendments extend the SOX 404(b) relief to only a "subset of companies – small, former EGCs," which are "a particular focus"

of his. Second, ICFR and the interaction between the SOX 404(a) and 404(b) processes has evolved and "financial reporting, ICFR and the audit process have become more systematized and integrated." Third, the vast majority of public companies will not be affected; smaller, low-revenue companies that will benefit from the rule represent in the aggregate less than 1% of total market cap – slightly over 500 companies – for which "the cost of unnecessary regulation is most acute." Finally, Clayton has not heard investors in foreign companies complain about the absence of an auditor attestation for those companies. While they may express concerns about the control environment in general, US companies differ in that they are subject to a "multi-faceted regulatory structure" that he believes provides for an effective control environment. For example, even in the absence of the 404(b) attestation requirement, these companies will "still be required to have their principal executive and financial officers certify that, among other things, they are responsible for establishing and maintaining ICFR and have evaluated and reported on the effectiveness of the company's disclosure controls and procedures, will continue to be subject to a financial statement audit by an independent auditor who is required to consider ICFR in the performance of that audit and will still be subject to the independent audit committee and other requirements of Sarbanes-Oxley."

- Ideally, **Commissioner Hester Peirce** would have made SOX 404(b) entirely optional for all companies, based on market demand. That not being possible, given the Congressional imperative, she was "disappointed" that the SEC had "not fully re-aligned the SRC and non-accelerated filer definitions." Nevertheless, she was pleased that at least some companies would benefit from the new rule, particularly biotech companies that would have more funds to invest in R&D – maybe even a new vaccine for a virus. She was concerned, however, given the overlap between financial audits and internal controls audits, that "auditors accustomed to being compensated handsomely for internal controls audits may have a financial incentive to increase certain assessments under the financial statement audit for these newly exempt issuers," in effect, shifting costs by folding "a back-door internal controls audit into their financial statement audits." Ultimately, though, in her view, the final rule was "a balanced one."

  You might recall that in her previous statement **regarding the proposed rules**, Peirce indicated that, while she supported the proposal, she had reservations about its scope. Although she viewed the proposal as "a step in the right direction," she did not believe that it went "far enough... The process of determining whether a company is an SRC and a non-accelerated filer, or an SRC and an accelerated filer, or outside of both categories is so complicated that even we at the SEC need diagrams to figure it out. The fact that we ourselves [are] struggling to understand our own regime does not bode well for smaller companies trying to follow our rules without the benefit of a staff of seasoned securities attorneys." The resulting complexity in the definitions, she said, required a navigation tool to comply.

- Commissioner Lee, who dissented on the vote, opened **her statement** with something between a protest and a lament: "in the face of extensive objection from investors, we strip away a layer of investor protection for financial reporting… Eliminating the auditor attestation removes a critical gatekeeping function that we know works to improve the reliability of financial reporting for investors. And we sacrifice this important protection for an admittedly modest cost reduction for issuers that could well be negated by an increased cost of capital." She was not at all convinced that the proposed amendments would encourage more IPOs. She argued that the reasons provided for the rule changes – reducing costs for low-revenue issuers and promoting capital formation – are questionable and not supported by evidence. There "just isn't evidence," she contended, to support the idea that companies will be encouraged to go public if they will be relieved "of modest additional costs for auditor attestation." While she acknowledged that there were "valid concerns on both sides of the policy choice," she expressed concern that investors' views had not been given adequate consideration: "There must be a limit," she said, "to the number of times we can credibly assert to investors that we act in their best interests by making policy choices they directly oppose." In her view, the elimination of the SOX auditor attestation requirement for low-revenue SRCs rolls back an important protection that SOX put in place following major accounting scandals and reduces the role of the auditor as gatekeeper in protecting internal controls – "the first line of defense in detecting and preventing material errors or fraud in financial reporting." Although auditors still review internal controls as part of their audits, she contends that there is "a significant difference between that review and an opinion from auditors as to the adequacy of internal controls. Attestations are designed to, and do, heighten and focus the attention of those in a position to ensure efficiency and compliance. Attestations increase accountability and they work. It's a kind of 'buck stops here' approach that is lost under the new rule."

- Although the SEC ultimately concluded that eliminating the attestation for low-revenue companies was, on balance, the right move, advocates of SOX 404(b) have emphasized that internal controls are the backbone of the financial statements, and some auditors view the attestation as more important than the audit itself. As **reported here**, in 2019, MarketWatch enlisted Audit Analytics to identify public companies with revenue under $100 million "that received a negative opinion from their auditors on their internal control over financial reporting. Audit Analytics counted 176 companies that received adverse opinions on their

internal controls since 2014. That represents 70% of all adverse internal control opinions issued for all public companies and 16.5% of the opinions issued for companies with less than $100 million in revenue that were required to do so." Similarly, **The Wall Street Journal** cited a 2017 academic study that "estimated that 20% of exempted firms had ineffective internal controls from 2007 to 2014. During that same period, just 11% of them actually disclosed such a weakness. They also found that 41% of exempted firms provided insufficient information to identify the causes of the weaknesses in their internal controls, compared with just 7% for firms that were complying with the Sarbanes-Oxley rules. According to the study, the smallest companies not currently exempt from required internal-controls audits would have paid an additional $73,165 a year in audit fees. The SEC estimated that annual costs related to outside audits are higher, around $225,000 per company."

- Some commenters on the proposal raised concerns that, "rather than targeting issuers where there may be relatively fewer benefits of the ICFR auditor attestation requirement, the amendments will remove this requirement for exactly those issuers where the benefits may be greatest." For example, they contended that "investors react more strongly to news of restatements or material weaknesses in ICFR… at small or low-revenue issuers." At the time of the proposal, former Commissioner Robert Jackson **criticized the proposal** on that basis and commissioned his office to study "how investors react to news of an internal control failure in two groups of companies: those that would receive a rollback of 404(b) under today's proposals and those who would not. The evidence is striking. The data show we are proposing today to roll back 404(b) for exactly the group of companies where investors care about the benefits of auditor attestation *most."* As part of its economic analysis, however, the SEC conducted additional analyses and did "not find any evidence that investors react more negatively to restatements or to auditors reporting material weaknesses in ICFR at low-revenue issuers than at higher-revenue issuers."
- Commenters also contended that the cost of the amendments would significantly outweigh the benefits and that the proposal did not adequately consider the risk of fraud, which could be particularly high for low-revenue companies. The SEC conducted supplemental analyses and did not find support for those contentions. In particular, the SEC analyzed the fraud risk and "did not find evidence based on the available data that low-revenue issuers that, like the affected issuers, are not within five years of their IPO ('seasoned' issuers), are more highly represented in the set of seasoned issuers associated with financial misconduct or financial reporting fraud than they are in the overall population of seasoned issuers. We also estimated the extent to which expanding the exemption from the ICFR auditor attestation requirement could affect the likelihood of the affected issuers engaging in such activities and include a quantification of the associated costs of this risk in our overall assessment of the potential costs of the amendments. Overall, this supplemental analysis does not cause us to change our primary conclusions regarding the potential effects of the amendments."

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