

SEC Continues on the Path of Simplifying Public Company Requirements

New Proposed Rules Aim to Eliminate Auditor's Attestation Requirement on Internal Controls under SOX 404(b) for Smaller Reporting Companies with less than \$100 million in Revenues

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Authors: [Era Anagnosti](#), [Colin Diamond](#), [Maia Gez](#), [Dov Gottlieb](#), [Michelle Rutta](#), [Danielle Herrick](#)

On May 9, 2019, the SEC proposed amendments¹ to effectively remove another regulatory burden for certain lower-revenue companies, including companies in the biotech and health care industries, in order to encourage more companies to access the public capital markets.² Specifically, the amendments would change the definitions of "accelerated filer" and "large accelerated filer" to exclude any company that qualifies as a "smaller reporting company" ("SRC") if it has annual revenues of less than \$100 million *and* a public float of less than \$700 million (the "SRC revenue test"). As a result of this change, these reporting companies would not be required to have their internal control over financial reporting ("ICFR") attested to by an independent auditor as otherwise required by Section 404(b) of the Sarbanes-Oxley Act ("SOX").

Background

SOX Section 404(a) requires almost all issuers, including SRCs, that file reports pursuant to Exchange Act Section 13(a) or 15(d) to establish and maintain ICFR and have their management annually assess the effectiveness of their ICFR. In addition, SOX Section 404(b) requires those issuers to have the auditing firm that audits their financial statements attest to the accuracy of management's assessment of the effectiveness of their ICFR ("ICFR auditor attestation"); however, SOX Section 404(c) exempts from the ICFR auditor attestation requirement issuers that are neither large accelerated nor accelerated filers.

Following the June 2018 amendments to the SRC definition, which expanded the number of companies eligible to benefit from the scaled disclosure requirements applicable to SRCs,³ some issuers are categorized as both SRCs and accelerated or large accelerated filers. As a result, these dually categorized SRCs are required, among other things, to continue to comply with the ICFR auditor attestation requirement.

The newly proposed amendments would reduce the number of companies that qualify as both SRCs and accelerated filers, but would not eliminate the overlap entirely.⁴ Companies should therefore carefully evaluate and monitor their filing status under applicable SEC rules.

¹ The SEC's proposing release is available [here](#).

² See Chairman Clayton's Statement at Open Meeting on Proposed Amendments to Sarbanes Oxley 404(b) Accelerated Filer Definition, available [here](#).

³ See our prior alert, "New and Proposed Rules on Smaller Reporting Companies, XBRL and Whistleblower Program", available [here](#).

⁴ For example, companies that qualify for SRC status under the public float test, as opposed to the revenue test, may still qualify as an accelerated filer.

Proposed Amendments

The following table provides an overview of the tests for a company to determine its filing status, with the SEC's proposed changes marked in brackets with an asterisk.

Overview of Tests to Become SRC, Accelerated Filer and Large Accelerated Filer*

	Company is a Smaller Reporting Company (or SRC) <i>if one of two tests is met:</i>	Company is an Accelerated Filer <i>if all four tests are met:</i>	Company is a Large Accelerated Filer <i>if all four tests are met:</i>
Initial Tests	<p>(1) SRC Public Float Test: Company has public float of less than \$250 million; OR</p> <p>(2) SRC Revenue Test: Company has annual revenues of less than \$100 million and either has no public float⁵ or a public float of less than \$700 million.</p>	<p>(1) One Year of SEC Filings: Company has been subject to requirements of Section 13(a) or 15(d) of the Exchange Act to file Exchange Act reports for at least 12 calendar months;</p> <p>(2) Filed One 10-K: Company has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act;</p> <p>(3) Public Float: Company has a public float of \$75 million or more, but less than \$700 million; AND</p> <p>(4) *[Not an SRC under SRC Revenue Tests: Company does <i>not</i> qualify as an SRC under the SRC Revenue Tests.]</p>	<p>(1) One Year of SEC Filings: Company has been subject to requirements of Section 13(a) or 15(d) of the Exchange Act to file Exchange Act reports for at least 12 calendar months;</p> <p>(2) Filed One 10-K: Company has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act;</p> <p>(3) Public Float: Company has a public float of \$700 million or more; AND</p> <p>(4) *[Not an SRC under SRC Revenue Tests: Company does <i>not</i> qualify as an SRC under the SRC Revenue Tests.]</p>
Subsequent Tests	<p>(1) SRC Public Float Test:</p> <ul style="list-style-type: none"> Must continue to meet public float threshold of less than \$250 million; <i>or</i> If public float was previously more than \$250 million, then Company does not qualify under SRC Public Float Test <i>unless</i> its public float is less than \$200 million; OR <p>(2) SRC Revenue Test:</p> <ul style="list-style-type: none"> Must continue to meet any thresholds previously satisfied (less than \$100 million in annual revenues <i>or</i> less than \$700 million in public float); If Company previously had revenues greater than \$100 million, then annual revenues must be less than \$80 million to qualify as an SRC under the SRC Revenue Test; <i>or</i> If Company had a public float of more than \$700 million, then public float must be below \$560 million to qualify as an SRC under the SRC Revenue Test. 	<ul style="list-style-type: none"> If currently an Accelerated Filer → Company ceases to be an Accelerated Filer and becomes a Non-Accelerated Filer if: <ul style="list-style-type: none"> (1) Public float falls below *[\$60 million]⁶; <i>or</i> (2) *[Company is eligible to be an SRC under the SRC Revenue Tests.] 	<ul style="list-style-type: none"> If currently a Large Accelerated Filer → Company ceases to be a Large Accelerated Filer if: <ul style="list-style-type: none"> (1) *Public float falls below *[\$560 million]⁷; <i>or</i> (2) *[Company is eligible to be an SRC under the SRC Revenue Tests]. A Large Accelerated Filer becomes an Accelerated Filer if: <ul style="list-style-type: none"> (1) Public float is *[\$60 million or more but less than \$560 million]; <i>and</i> (2) *[Company is <i>not</i> eligible to be an SRC under the SRC Revenue Tests.] A Large Accelerated Filer becomes a Non-Accelerated Filer if: <ul style="list-style-type: none"> (1) Public float falls below *[\$60 million]; <i>or</i> (2) *[Company is eligible to be an SRC under the SRC Revenue Tests.]

All SEC reporting companies should monitor their filing status and make a formal assessment annually, which is then reflected on the cover pages of their SEC filings for the following year (or in the case of SRC status, as early as the second quarter Form 10-Q once the determination can be made). Public float is assessed as of the last business day of the issuer's most recently completed second fiscal quarter. Annual revenues are assessed as of the most recently completed fiscal year for which audited financial statements are available, which under current SEC guidance for SRCs is the most recent fiscal year completed before the last business day of the second fiscal quarter.⁸

⁵ A registrant may have no public float because it has no public common equity outstanding or no market price for its common equity exists. This only applies to the SRC Revenue Test, since an entity with equity securities outstanding but not trading in any public trading market is not able to qualify as an SRC on the basis of the SRC Public Float Test.

⁶ Proposed amendments would increase this from \$50 to \$60 million.

⁷ Proposed amendments would increase this from \$500 million to \$560 million.

⁸ See "A Small Entity Compliance Guide for Issuers," available [here](#).

Potential Impact of the Proposed Amendments

The proposed amendments are aimed at a subset of issuers for whom the added step of an ICFR auditor attestation is likely to add significant costs and is unlikely to enhance financial reporting or investor protection. For these lower-revenue companies, the cost of compliance with SOX 404(b) is potentially very impactful in terms of diverting resources from core business needs. For example, one company estimated that it will spend \$400,000 annually on compliance with SOX 404(b) and another estimated that relief from the SOX 404(b) requirements would decrease compliance costs by 35 percent.

According to SEC data, 36 percent of companies affected by the proposal were in the pharma/biotech space, and although these companies may have larger market capitalizations, they are often in the early stages of product development and, consequently, often have no or very low revenues, making their financial characteristics much closer to those of non-accelerated filers. The proposing release also notes that the proposed amendments are targeted at issuers whose representation in public markets has decreased by about 65 percent over the past 20 years, and may be a positive factor in these companies' decision to access the public capital markets.

Key Takeaways

While the proposed amendments have not been finalized, the following are key takeaways for public companies:

- *Exiting Emerging Growth Company ("EGC") Status* – Companies that have recently exited or will be exiting EGC status (and which had not been previously required to comply with SOX 404(b)) should pay close attention to whether they would qualify as a non-accelerated filer under the proposed rules and thus might be able to continue to avoid the cost of the ICFR auditor attestation;
- *SRC Status* – It will be important for many companies to re-evaluate whether they qualify as an SRC, since if these proposed rules are adopted, qualifying as an SRC could result in significant additional benefits;
- *Complexity of Proposed Regime* – As noted by Commissioner Pearce⁹, "[t]he 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 we [at the SEC are] ourselves struggling to understand our own regime[, which] does not bode well for smaller companies trying to follow our rules without the benefit of a staff of seasoned securities attorneys."
- *Monitor Status of Proposal* – Companies should monitor the status of the proposed amendments and any future adopted rules. It will also be important to focus on any significant clarifications of any new rules, including, for example, any clarification on the timing as to when annual revenues are measured – the most recent fiscal year prior to the 10-K filing or the fiscal year preceding the last business day of the most recently completed second quarter – to determine whether an auditor attestation is or is not required to be included in a Form 10-K. Whether a company is looking at nearly two-year-old revenue data or whether they need to wait and see what their revenue is closer to the time of determination may significantly impact potential compliance.

The SEC has requested comments from any interested persons regarding the proposed rule amendments. Comments should be received by the SEC within 60 days of publication in the *Federal Register*.

⁹ Commissioner Pearce's statement is available [here](#).

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States

T +1 212 819 8200

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White & Case LLP
701 Thirteenth Street, NW
Washington, District of Columbia 20005-3807
United States

T +1 202 626 3600