114TH CONGRESS
2d Session
HOUSE OF REPRESENTATIVES
REPORT
114–588

FOSTERING INNOVATION ACT OF 2015

MAY 23, 2016.—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. 4139]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 4139) 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

Introduced by Representatives Kyrsten Sinema and Michael Fitzpatrick on December 1, 2015, H.R. 4139, the Fostering Innovation Act of 2015, extends the exemption from Section 404(b) of the Sarbanes-Oxley Act (SOX) for emerging growth companies (EGCs) that would otherwise lose their SOX 404(b) exempt status at the end of the five-year EGC period that exists under current law. The legislation extends the SOX 404(b) exemption 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 ($700 million public float) with the Securities and Exchange Commission (SEC). SOX Section 404(b) costs disproportionately burden smaller companies and startup enterprises that do not have sufficient revenue streams to devote to SOX compliance costs.

59–006

BACKGROUND AND NEED FOR LEGISLATION

Title I of the Jumpstart Our Business Startups Act (JOBS) (Pub L. 112–106) established EGCs as a new category of issuer under the federal securities laws. These EGC issuers have less than $1 billion in annual revenues or $700 million in public float when they register with the SEC. EGCs 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 of the JOBS Act encourages small company public offerings and ensures that they move to full compliance with regulatory requirements as they become large enough to support the legal, accounting, and compliance infrastructure typical of mature enterprises.

Background on the compliance burden associated with SOX Section 404(b)

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 the SOX Act's compliance costs is Section 404(b), which requires a public company's external auditor to attest to, and report on, management's assessment of the company's internal controls as required by Section 404(a) of SOX. 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. According to a 2008 report by the Heritage Foundation:

> 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. CRA International's survey data indicates that total year-one Section 404 implementation cost per company with market capitalization between $75 million and $700 million, known as a small accelerated filer, is $1.5 million, or 0.46 percent of its revenue; and that per company with market capitalization above $700 million, known as a large accelerated filer, is $7.3 million, or 0.09 percent of its revenue. A more recent estimate pegged the average cost of direct compliance costs and outside audit fees in 2006 at 2.5 percent of a company's revenue.

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

> While 404 auditor costs declined 5.4% from 2006 as the auditor scope of work narrowed, these costs were offset by a reported five percent 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 after conducting a large web-based survey of publicly held companies over a period from December 2008 to January 2009. The Study found that for companies that were already complying with Section 404(b), the mean total Section 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. Even though the overall mean 404 compliance costs had dropped 19% from the pre-guidance cost, for smaller reporting companies, the drop was not as significant. In fact, the 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.

More recently, a May 2014 survey conducted by compliance and audit consultant Protiviti similarly found that approximately 53 percent of large organizations currently spend $1 million or more each year on SOX compliance, and 30 percent 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."

At a December 2, 2015 Capital Markets and Government Sponsored Enterprises Subcommittee hearing to consider the Fostering Innovation Act, Mr. Brian Hahn, Chief Financial Officer of GlycoMimetics, testified that the SOX 404(b) auditor attestation requirement "provides little-to-no insight into the health of an emerging biotech company—but is extremely costly for a pre-revenue innovator to comply with."

The significant burdens associated with SOX Section 404(b) compliance disproportionately affect smaller public companies, diverting resources from growth to regulatory costs and harming the ability of these firms to compete against larger peers and foreign competitors. According to the Heritage study, "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 that:

> [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 . . . the 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. Moreover . . . the 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. During this current economic downturn, many publicly held community banks are having a difficult time raising capital and in many cases, have had to postpone or cancel their capital raising plans.

The Fostering Innovation Act will promote the continued growth and financial success of small and innovative companies. As indicated previously, the Act relieves a subset of EGCs from Section 404(b) compliance for up to ten years, provided that their annual revenue is not greater than $50 million and their public float is less than $700 million (a company is an EGC if its annual revenue does not exceed $1 billion and its public float is less than $700 million); the Act is therefore limited in its application to those EGCs that are truly small companies, in recognition of the fact that small business economic life-cycles require a greater time period in which to build up to full compliance with public company regulations. Thus, as Mr. Hahn from GlycoMimetics concluded at the December 2nd hearing, "Legislation like the Fostering Innovation Act will ensure that growing companies have the opportunity to be successful on the public market without being forced to siphon off innovation capital to spend on costly compliance burdens that do not inform emerging biotech investors."

HEARINGS

The Committee on Financial Services' Subcommittee on Capital Markets and Government Enterprises held a hearing examining matters relating to H.R. 4139 on December 2, 2015.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on March 2, 2016, and ordered H.R. 4139 to be reported favorably to the House without amendment by a recorded vote of 42 yeas to 15 nays (recorded vote no. FC–98), 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 recorded votes on the motion to report legislation and amendments thereto. The sole re-

corded vote in committee was a motion by Chairman Hensarling to report the bill favorably to the House without amendment. That motion was agreed to by a recorded vote of 42 yeas to 15 nays (Record vote no. FC–98), a quorum being present.

Record vote no. FC-98

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Waters (CA)		X	
Mr. King (NY)	X			Mrs. Maloney (NY)	X		
Mr. Royce	X			Ms. Velázquez		X	
Mr. Lucas	X			Mr. Sherman		X	
Mr. Garrett	X			Mr. Meeks		X	
Mr. Neugebauer	X			Mr. Capuano		X	
Mr. McHenry	X			Mr. Hinojosa			
Mr. Pearce	X			Mr. Clay		X	
Mr. Posey	X			Mr. Lynch		X	
Mr. Fitzpatrick	X			Mr. David Scott (GA)	X		
Mr. Westmoreland				Mr. Al Green (TX)		X	
Mr. Luetkemeyer	X			Mr. Cleaver		X	
Mr. Huizenga (MI)	X			Ms. Moore		X	
Mr. Duffy	X			Mr. Ellison		X	
Mr. Hurt (VA)	X			Mr. Perlmutter		X	
Mr. Stivers	X			Mr. Himes		X	
Mr. Fincher	X			Mr. Carney	X		
Mr. Stutzman	X			Ms. Sewell (AL)		X	
Mr. Mulvaney				Mr. Foster	X		
Mr. Hultgren	X			Mr. Kildee	X		
Mr. Ross	X			Mr. Murphy (FL)	X		
Mr. Pittenger	X			Mr. Delaney	X		
Mrs. Wagner	X			Ms. Sinema	X		
Mr. Barr	X			Mrs. Beatty		X	
Mr. Rothfus	X			Mr. Heck (WA)	X		
Mr. Messer	X			Mr. Vargas	X		
Mr. Schweikert	X						
Mr. Guinta	X						
Mr. Tipton	X						
Mr. Williams	X						
Mr. Poliquin	X						
Mrs. Love	X						
Mr. Hill	X						
Mr. Emmer	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. 4139 will reduce regulatory compliance costs for Emerging Growth Companies 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.

COMMITTEE COST ESTIMATE

The Committee adopts as its own 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, April 18, 2016.

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. 4139, the Fostering Innovation Act of 2015.

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.

Enclosure.

H.R. 4139—Fostering Innovation Act of 2015

H.R. 4139 would extend the exemption period for some emerging growth companies from having an auditor attest to and report on internal control reports.

Securities and Exchange Commission (SEC) rules require the issuers of securities to file assessments of their internal control structures and procedures for financial reporting and to have those reports be attested to and reported on 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 of an auditor's attestation of their internal control report for up to five years after their first sale of equity securities. H.R. 4139 would extend the maximum exemption period to 10 years.

Based on information from the SEC, CBO estimates that implementing H.R. 4139 would cost less than $500,000 for personnel and administrative costs to revise SEC rules. However, the SEC is authorized to collect fees sufficient to offset its annual appropriation; therefore, CBO estimates that the net effect on discretionary spending would be negligible, assuming appropriation actions consistent with that authority.

Enacting H.R. 4139 would not affect direct spending or revenues; therefore, pay-as-you-go procedures do not apply. CBO estimates that enacting H.R. 4139 would not increase net direct spending or on-budget deficits in any of the four consecutive 10-year periods beginning in 2027.

H.R. 4139 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

If the SEC increases fees to offset the costs of implementing the bill, H.R. 4139 would increase the cost of an existing mandate on private entities required to pay those fees. Based on information from the SEC, CBO estimates that the aggregate cost would be minimal and would fall well below the annual threshold for private-sector mandates established in UMRA ($154 million in 2016, adjusted annually for inflation).

The CBO staff contacts for this estimate are Stephen Rabent (for federal costs) and Logan Smith (for private-sector mandates). The estimate was approved by H. Samuel Papenfuss, Deputy Assistant Director of Budget Analysis.

FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates Reform Act.

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

H.R. 4139 does not contain any congressional earmarks, limited tax benefits, or limited tariff benefits as defined in clause 9 of rule XXI.

DUPLICATION OF FEDERAL PROGRAMS

Pursuant to section 3(g) of H. Res. 5, 114th Cong. (2015), the Committee states that no provision of H.R. 4139 establishes or reauthorizes a program of the Federal Government known to be duplicative of another Federal program, a program that was included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139, or a program related to a program identified in the most recent Catalog of Federal Domestic Assistance.

DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, 114th Cong. (2015), the Committee states that H.R. 4139 contains no directed rulemaking.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1: Short title

This section cites H.R. 4139 as the "Fostering Innovation Act of 2015."

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 Emerging Growth Companies (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 ($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 (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

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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.

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MINORITY VIEWS

H.R. 4139 would amend the Sarbanes-Oxley Act of 2002 (SOx) to provide a 10 year exemption from the Section 404(b) auditor attestation requirements for companies who cease to be Emerging Growth Companies (EGCs), provided that they have average annual gross revenues of less than $50 million and do not meet the Securities and Exchange Commission's (SEC) definition of "large accelerated filer" (i.e., the company has a public float less than $700 million).

Congress passed SOx nearly 15 years ago in the wake of several high-profile corporate and accounting scandals, including those of Enron, Tyco International, Adelphia and WorldCom, which collectively cost investors billions of dollars and simultaneously undermined confidence in U.S. capital markets. A key component of SOx was Section 404(b), which requires that a company's auditor include an assessment of the adequacy of the company's internal controls that govern financial statements.

H.R. 4139 would amend SOx to exempt EGCs for up to a decade from the Section 404(b) audit if they meet certain revenue and public float requirements. This is both unnecessary and harmful.

First, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111–203) has already provided relief to small issuers, exempting "non-accelerated filers" (i.e., companies with less than $75 million in public float) from the Section 404(b) requirement. In total, approximately 60 percent of issuers are exempt pursuant to this provision. Second, the Jumpstart Our Business Startups Act of 2012 (P.L. 112–106) expanded upon this relief by providing an exemption from Section 404(b) for EGCs, either until five years after the EGCs first sale of common equity securities in a public offering; the last day of the fiscal year during which the EGC had total annual gross revenues of $1 billion (adjusted for inflation every five years); the date on which the EGC has, during the previous three-year period, issued more than $1 billion in nonconvertible debt; or the date on which it is deemed to be a "large accelerated filer."

The additional exemptions provided under H.R. 4139—which would further delay compliance for up to a decade for certain companies—is not necessary in light of the plentiful exemptions already available.

Additionally, the further exemptions may prove to be harmful both to investors and to the very companies H.R. 4139 purports to help. In a 2013 study, the Government Accountability Office (GAO) found that companies that are not required to comply with the Section 404(b) audit requirement restated their financials more often than those that were required to comply. Restatements of financials can have a devastating impact on a company's health and potential growth, particularly for less established firms.

Removing Section 404(b) requirements likewise is harmful to investors, with 72 percent of institutional investors reporting in a 2015 study by the Public Company Accounting Oversight Board's Investor Advisory Group that they rely on the Section 404(b) audits when making investment decisions. Further, Joseph Carcello, a CPA and member of the SEC's Investor Advisory Committee, testified to the Committee that auditors, rather than management, detect approximately 75 percent of the internal control deficiencies in these small companies. Mr. Carcello also informed the Committee that management tends to downplay internal control deficiencies as less severe, and auditors must frequently override these classifications.

In short, auditor reporting on public companies provides substantial benefits to investors and to the companies. It promotes confidence in U.S. markets, strengthens internal controls, and prevents fraud. For these reasons, the Minority opposes H.R. 4139.

MAXINE WATERS.

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