Consumer Federation of America

July 29, 2019

Ms. Vanessa Countryman
Director, Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-06-19
Amendments to the Accelerated Filer and Large Accelerated Filer Definitions

Dear Ms. Countryman:

I am writing on behalf of the Consumer Federation of America[1] to express our strong opposition to the proposed revisions to the definitions of accelerated filer and large accelerated filer. The proposal to add a revenue test to these definitions would have the effect of exempting a broader swath of public companies from the requirement to include an independent auditor assessment of internal controls over financial reporting (ICFR) as part of the financial statement audit, a key reform adopted in response to the wave of corporate frauds that decimated the public markets in the early 2000s. The proposal would roll back those reforms for several hundred large, but "low revenue" public companies without providing any credible support for the claim that doing so would promote capital formation and despite compelling evidence that taking this action could undermine the quality and reliability of the affected companies' financial reporting. We therefore urge you to withdraw this proposal.

According to the Release, the purpose of the proposed revisions is "to promote capital formation for smaller reporting issuers, by more appropriately tailoring the types of issuers that are included in the categories of accelerated and large accelerated filers." The gist of the SEC's argument is that, by reducing these companies' compliance costs, the proposal would enhance their "ability to preserve capital" and could be "a positive factor in the decision of additional companies to register their offerings or a class of their securities, which would provide an increased level of transparency and investor protection with respect to those companies." The Release suggests that these purported benefits could be realized "without significantly affecting

[1] The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.

the ability of investors to make informed investment decisions based on the financial reporting of those issuers." None of these claims holds water.

The SEC Created the Regulatory Inconsistency its Proposal Would "Resolve"

Contrary to the arguments put forward in the Release, the proposal is not aimed at "smaller" companies. Smaller companies (non-accelerated filers), as well as all but the very largest newer public companies (emerging growth companies or EGCs), are already exempt from the ICFR auditor attestation requirement. In contrast, the issuers affected by this proposed definition change would include quite large companies with substantial market cap and significant investor exposure.

The SEC claims the change in definitions is nonetheless needed to "resolve inconsistencies" between the definition of smaller reporting company (SRC) and the definitions of accelerated filer and large accelerated filer. But that is an inconsistency that the SEC itself created when it revised the definition of smaller reporting company a year ago. The absurdity of the situation the Commission created with its expansive SRC definition can be seen in the fact that some companies now simultaneously qualify as smaller reporting companies and large accelerated filers.[2] Unless the Commission's goal is to gradually exempt all public companies from basic obligations designed to ensure accurate financial reporting, the logical solution is to roll back the SRC definition so that it includes only smaller companies, not to further narrow the definitions of accelerated filer and large accelerated filer, as this proposal would do.

The Proposal Will Not Impact Companies' Decisions to Go Public

There is simply no basis to claim, put forward in the Release, that the proposed change would have a material impact on companies' decisions regarding whether to go public. The Release notes, as if it were relevant to this proposal, that there has been a 65% decline in the number of issuers listed on major exchanges with market capitalizations below $700 million between 1998 and 2017 and a 60% decline in the number of listed issuers with less than $100 million in revenue. The implication is that the cost of compliance with the ICFR auditor attestation requirement has contributed materially to that decline. However, the Release fails to make clear what percentage of the reported decline in listings occurred in the years immediately before SOX was adopted and implemented – a percentage that is likely quite substantial given that the period in question included both the bursting of the tech stock bubble and the wave of accounting scandals that led to the passage of SOX. At the very least, if the Commission wants to understand the impact of the ICFR auditor attestation requirement on capital formation, it should focus its attention on the period after the passage and implementation of SOX.

At the same time, the Release fails to consider the impact that a variety of other factors played in that listings decline. These include, first and foremost, the proliferation and expansion of exemptions that have made it easier for companies to raise money in private markets.[3] As

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[2] See footnote 25 of the Release.

[3] *See, e.g.*, Elisabeth de Fontenay, The Deregulation of Private Capital and the Decline of the Public Company, 68 HASTINGS L. J. 445 (2017). (Electronic copy available at: https://ssrn.com/abstract=2951158) ("[W]hile critics blame the increase in regulation for the decline of public equity, the ongoing deregulation of private capital raising

Elisabeth de Fontenay has argued persuasively in her paper on "The Deregulation of Private Capital," the ongoing, three decades long deregulation of private capital raising has fundamentally undercut the value associated with going public, with the predictable result that it has led to both a decline in the percentage of companies that choose to go public and an increase in the age and size at which companies that do go public make that transition.[4] Other relevant factors include: the impact of record low interest rates, which have made debt an attractive financing option, and the extreme market volatility, which has made an IPO an unattractive option, as well as the high rate of corporate consolidations, that existed during much of the period.

Instead of seriously evaluating these directly relevant issues, the Release states merely that research into the ties between SOX and going public has been "inconclusive." One must look deep within the economic analysis to find a quiet admission that, "the impact of the proposed amendments on the number of publicly traded companies may be limited." Had the Release provided a fuller examination of this issue, it would quickly have become apparent that there is simply no credible case to be made that this proposal would have any meaningful impact on companies' decisions to go public, because it does not affect the fundamentals that drive those decisions.

Any Increase in "Capital Preservation" is Likely to be Minimal At Best

The argument that the proposal would promote capital formation by enabling companies to divert money they currently spend on the ICFR auditor attestation to other more productive purposes is only slightly more credible. Even if one accepts the Release's estimates regarding average savings companies would likely realize if exempted from the auditor attestation requirement, the overall annual savings that result would be somewhere in the neighborhood of $60 and $100 million.[5] In other words, the market-wide capital "preservation" expected to result from this proposal is likely less than what the SEC counts as "low revenue" for the purposes of classifying companies as smaller reporting companies. In short, even if you accept the SEC's optimistic estimates, the purported benefit of this approach is far too modest to justify the very real risk that the proposal, if implemented, would seriously undermine the quality of financial reporting, potentially increasing the cost of capital for affected companies.

Furthermore, the proposal will only deliver the promised cost savings if it results in a significant decrease in ICFR testing. However, as the Release itself acknowledges, assessing the effectiveness of internal controls over financial reporting is an essential component of even financial statement only audits. In particular, the auditor is required as part of the financial statement audit to "identify and assess the risks of material misstatements." To do so, the auditor

arguably played the greater role. That is, even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately.")

4 *Id.*

5 If 285 companies save an average of $210,000 a year in audit and non-audit costs related to ICFR auditor attestation, it would result in total savings of roughly $60 million. If 400 companies save an average of $250,000, the resulting savings would total roughly $100 million.

must "obtain a sufficient understanding of each component of [ICFR] to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures" based on that assessment. That includes "evaluating the design of the controls relevant to the audit and determining whether the controls have been implemented." As a result, it is reasonable to expect that a significant portion of any reduced testing or audit procedures around controls that results from eliminating the auditor's ICFR attestation would be offset by increased testing of controls for the purposes of the financial statement audit risk assessment. If, on the other hand, testing of controls as part of the financial statement only audit is not enhanced, that would suggest that the risks of the proposal are far greater than the Commission is prepared to admit.

ICFR, and the Auditor Attestation, Promote Improved Financial Reporting

In discussing its proposed approach, the Release tends to understate the value of ICFR generally, and the auditor attestation specifically, in promoting the reliable financial reporting on which our system of capital formation depends. As recently departed SEC Chief Accountant Wesley R. Bricker stated in a 2017 speech, "It is hard to think of an area more important than ICFR and the related assessment frameworks to our shared objective of providing high-quality financial information that investors can rely on."[6] Bricker went on to note that, "Investors tend to incorporate disclosure of ICFR deficiencies in the price they are willing to pay for a stock. For example, companies disclosing material weaknesses are more likely to experience increased cost of capital, and to face more frequent auditor resignations and restatements." He cited recent academic research suggesting: that companies disclosing internal control deficiencies have credit spreads on loans about 28 basis points higher than that for companies without internal control deficiencies; and that, after disclosing an internal control deficiency for the first time, companies experience a significant increase in cost of equity, averaging about 93 basis points.

One result is that management may be reluctant to acknowledge any weakness in ICFR, given the potentially harmful impact doing so could have on its cost of capital. That makes the independent auditor assessment of ICFR all the more important in providing the public with reliable information about control deficiencies. In this regard, it is worth noting that U.S. public companies have been required since 1977 to adopt and maintain a system of internal controls sufficient to provide "reasonable assurance" that "transactions are recorded as necessary to permit preparation of financial statements" in conformity with Generally Accepted Accounting Procedures (GAAP).[7] The relatively new ICFR auditor attestation provision was adopted in response to overwhelming evidence that woefully inadequate compliance with the internal controls requirement was a major contributing factor in the wave of accounting scandals that led to SOX's passage. It reflects the basic reality that management is often reluctant to devote resources to functions that do not directly contribute to the bottom line, a reluctance that may be even more prevalent at low revenue companies.

[6] Wesley R. Bricker, Remarks before the Annual Life Sciences Accounting & Reporting Congress, "Advancing Effective Internal Control and Credible Financial Reporting," March 21, 2017.

[7] *Id.*

Bricker went on to discuss the benefits companies enjoy when they remediate ineffective ICFR. Doing so "tends to be followed by improved financial reporting quality, reduced cost of capital, and improved operating performance," according to Bricker. As evidence, he cited the fact that companies that have remediated their prior disclosed internal control deficiencies exhibit an average decrease in market-adjusted cost of equity of 151 basis points; and remediating companies also experience increases in investment efficiency and in operating performance, suggesting that accounting information generated by effective ICFR is more useful for managerial decision-making.[8] Given the much longer persistence of ICFR deficiencies at companies that are exempt from the auditor attestation, as documented in the Release, this suggests that the auditor attestation requirement delivers benefits to companies that aren't adequately reflected in the proposal.

The Economic Analysis Documents Extensive Risks Associated with the Proposal

While the Commission seeks to dismiss with a shrug the risks that its proposal would undermine the quality of financial reporting, the discussion of the topic in the economic analysis tells a different story. To begin with, the Release presents evidence of an extraordinarily high level of ineffective ICFR among non-accelerated filers and much longer persistence of ICFR problems at companies that are exempt from the auditor attestation requirement. It also finds that, among companies with less than $100 million in revenue, non-accelerated filers are more likely to restate their financial statements than accelerated filers, suggesting that the ICFR attestation plays a material role in preventing restatements, even at low revenue companies. Moreover, as Commissioner Jackson documented in the public statement he released at the time of the proposal, the markets impose a much heftier penalty on small companies that restate than they do on larger companies. As Commission Jackson stated, the proposal would "roll back 404(b) for exactly the group of companies where investors care about the benefits of auditor attestation most."

Although it is given short shrift in the body of the proposal, the economic analysis discusses, at some length, the considerable evidence that exists that the ICFR auditor attestation requirement leads to more effective ICFR, and thus to more reliable financial statements. It mentions, for example, studies that have found an association between a failure to maintain effective ICFR and both a higher rate of future restatements and lower earnings quality, a higher rate of future fraud revelations, more profitable insider trading, and less accurate analyst forecasts. It notes, moreover, that ICFR auditor attestations have also generally been found to be directly associated with financial statements that are more reliable than in the absence of these attestations, and that material weaknesses in ICFR, restatements, and low earnings quality have all been associated with a higher cost of debt or equity capital. It even acknowledges that, "The ICFR auditor attestation requirement also can enhance capital formation to the extent that it improves overall investor confidence, for which there is some suggestive evidence, and thus encourages investment in public markets."

In keeping with this evidence, the economic analysis recognizes that there are considerable risks associated with the proposal. This includes the fact that "smaller reporting

[8] *Id.*

issuers" are both "disproportionately represented in populations of issuers with ineffective ICFR and financial statements that require material restatement" and "less likely to have significant external scrutiny in the form of analyst and media coverage and monitoring by institutional owners, which could otherwise provide another source of discipline to maintain the reliability of financial statements." As a result, it acknowledges the very real possibility that, "extending the exemption from the ICFR auditor attestation requirement to the affected issuers may decrease the likelihood that, when these issuers have underlying material weaknesses in ICFR, these material weaknesses are detected and disclosed," which, over time, "may result in a lower number of issuers establishing or maintaining effective ICFR."

Claims that Low Revenue Issuers Are Low Risk Are Unfounded

Having made a compelling case against the proposal in the economic analysis, the Release sweeps aside these concerns by making the patently absurd argument that low revenue issuers "could be less susceptible, on average, to at least certain kinds of misstatements." Specifically, it suggests that "low revenue" companies are inherently "less susceptible to the risk of certain kinds of misstatement, such as those related to revenue recognition." The underlying assumption appears to be that the low revenue companies affected by the proposal are low revenue by choice, perhaps because they are at an early stage in product development and not expected to produce revenue in the near term. Where this is the case, however, the requirement to implement scaled, risk-based audits of ICFR should already result in reduced testing and reduced cost for the ICFR attestation.[9]

The fundamental flaw in this argument, and the proposed definition change itself, is that they fail to take into account the many low revenue companies that are struggling to become high revenue companies. For such companies, their ability to attract capital may depend primarily on their ability to convince analysts and investors that their revenues are strong and steadily rising. As a result, their incentives to fudge the numbers around revenue recognition are among the highest for any class of company. Yet they, too, would be exempt from the ICFR auditor assessment under the SEC's misguided proposal. In short, as Commissioner Jackson noted, the firms affected by the proposal would likely include "high-growth companies where the risk, and consequences, of fraud are greatest" and "where the benefits of the auditor's presence are highest."[10]

A recent SEC enforcement action against Osiris Therapeutics and four of its former executives perfectly illustrates the concern.[11] Osiris was a low revenue company led by executives who, according to the SEC's allegations, were willing to engage in repeated,

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[9] The Release suggests that ICFR audit costs have dropped significantly since this standard was adopted. If the Commission has evidence that it is not producing appropriately scaled ICFR audits, and associated cost reductions, it should focus on that, rather than broadly exempting a set of companies that pose very different risk characteristics from the ICFR auditor attestation requirement.

[10] Commissioner Robert J. Jackson Jr., Statement on Proposed Amendments to Sarbanes Oxley 404(b) Accelerated Filer Definition, May 9, 2019, https://www.sec.gov/news/public-statement/jackson-statement-proposed-amendments-accelerated-filer-definition.

[11] Osiris Therapeutics, Inc., et al. (Release No. LR-23978; Nov. 3, 2017), https://www.sec.gov/litigation/litreleases/2017/lr23978.htm.

egregious revenue recognition violations in order to convince analysts and other market participants that the company's revenues were experiencing strong and steady growth. In addition to engaging in numerous revenue recognition violations, a charge that the company settled without admitting or denying wrongdoing, the SEC alleged that the executives provided false attestations regarding the adequacy of the company's ICFR.

The facts of the case suggest that a well-designed ICFR audit might have uncovered the control deficiencies, and related revenue recognition violations, more quickly. At the very least, the case provides a timely reminder that, far from being reliably associated with low risk related to revenue recognition, low revenue may sometimes pose a heightened risk associated with this most common of accounting violations.

Conclusion

Ultimately, like many deregulatory proposals advanced in the name of capital formation, this proposal is based on the false premise that investor protection and capital formation are competing and largely incompatible aims. This attitude ignores extensive evidence that capital formation succeeds best when the providers of capital trust the integrity of the markets and the reliability of the information on which they base their investment decisions. This is more important, not less, for those public companies that, in competing for investor dollars, must overcome disadvantages associated with being less well known to investors and subject to less extensive third-party validation. By further undermining the reliability of financial reporting by these companies (in this case, large but low revenue companies), this proposal raises the risk that affected issuers will face higher costs of capital from investors to compensate for the heightened risks associated with weaker ICFR. Because it will not make any meaningful contribution to capital formation but will undermine the quality and reliability of financial reporting, we urge you to withdraw this ill-advised and unfounded proposal.

Respectfully submitted,

Barbara Roper
Director of Investor Protection