

SEC Seeks Public Comment Related to Study of the Impact of Sarbanes-Oxley Section 404(b) on Companies With Public Float Between \$75 Million and \$250 Million

The Sarbanes-Oxley Act of 2002 (the “Act”) was signed into law on July 30, 2002.¹ The Act was adopted in the wake of a series of high-profile corporate scandals involving companies such as Enron and Worldcom. The Act imposed new substantive corporate governance and disclosure requirements on all SEC reporting companies in an effort to improve transparency and make such companies more accountable to investors. Section 404(a) of the Act requires that management provide an assessment of the effectiveness of internal control over financial reporting in their annual 10-K report. Section 404(b) requires that an independent auditor attest to, and report on, management’s assessment regarding the effectiveness of those internal controls.

The costs incurred by companies in implementing and complying with these reforms have been high.² In addition, it has been determined that smaller companies (as measured by public float) have generally incurred higher scaled costs (*i.e.*, costs as a fraction of asset value) than their larger counterparts with respect to Section 404 compliance.³ In recognition of the disproportionately negative economic burden of Section 404 compliance on smaller companies, Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) exempts reporting companies with public float under \$75 million from the auditor attestation provisions of Section 404(b).⁴

Section 989G of the Dodd-Frank Act also requires the SEC to conduct a study to determine how Section 404(b) compliance costs could be reduced for companies whose “market capitalization” is between \$75 million and \$250 million, while maintaining investor protections. Neither the Dodd-Frank Act nor the SEC rules define “market capitalization,” but for purposes of the study, the SEC will use public float as the appropriate measure of market capitalization.⁵ The Dodd-Frank Act also mandates that the study consider whether any methods of reducing the compliance burden or a complete exemption for such companies from Section 404(b) compliance would encourage such companies to list on U.S. exchanges in their initial public offerings (“IPOs”). Importantly, the required study will not evaluate the compliance burden of Section 404(a). The SEC must complete and submit a report on the study to Congress by April 20, 2011.

¹ See P.L.107-204, the Public Company Accounting Reform and Investor Protection Act.

² See, e.g., Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements (September 2009), available at http://www.sec.gov/news/studies/2009/seox-404_study.pdf. For further discussion, see our firm memorandum entitled, *SEC Office of Economic Analysis Releases Results of Study About Sarbanes-Oxley Section 404* (November 4, 2009).

³ *Id.*

⁴ Such companies are still required to comply with Section 404(a), however. Section 989G of the Dodd-Frank Act added a new Section 404(c) to the Sarbanes-Oxley Act of 2002 which provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934. The Dodd-Frank Act is codified as Pub. L. No. 111-203 (July 21, 2010).

⁵ Public float is the aggregate worldwide market value of an issuer’s voting and non-voting common equity held by its non-affiliates. Among other things, it is the measure used in SEC rules for determining “accelerated filer” and “large accelerated filer” status. In addition, the SEC has historically used public float in its actions to phase issuers into Section 404 compliance.

CAHILL

On October 14, 2010, the Securities and Exchange Commission (“SEC”) issued a release requesting public comment related to the study.⁶ The SEC is requesting public comment on twenty-three topics related to Section 404(b) compliance by companies with public float between \$75 million and \$250 million. The topics are summarized in the attached annex. The comment period is 45 days.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

⁶ Available at <http://www.sec.gov/rules/other/2010/34-63108.pdf>.

Annex

Topics for Public Comment

The topics on which the SEC is requesting public comment related to Section 404(b) compliance by companies with public float between \$75 million and \$250 million are summarized as follows and include:

- quantitative and qualitative information regarding cost trends of Section 404(b) compliance over time;
- current costs related to Section 404(b) compliance in relation to overall Section 404 compliance costs, and changes to this relative cost over time;
- characteristics of internal controls, management’s evaluation process and corporate governance that distinguish such companies from other issuers;
- unique audit planning and performance characteristics of such companies;
- the incremental effort needed for preparers and auditors to comply with Section 404(b) for an integrated audit beyond efforts that would already be incurred to comply with the requirements for a financial statement only audit;
- whether and how prior initiatives by the SEC, Public Company Accounting Oversight Board (“PCAOB”), Committee of Sponsoring Organizations of the Treadway Commission and other organizations have reduced Section 404(b) compliance costs;
- whether and how PCAOB Auditing Standard No. 5 has reduced Section 404(b) compliance costs versus PCAOB Auditing Standard No. 2;
- the possibility that guidance or rules issued by the SEC, PCAOB or others could further reduce the Section 404(b) compliance burden, while maintaining investor protection, and any specific recommendations concerning such rules or guidance;
- the impact of Section 404(b) compliance by such companies on investor protection, investor confidence and the cost of capital;
- the degree to which investor protection, investor confidence, and the cost of capital would increase or decrease as a function of any specific recommendations by which the SEC, PCAOB or others might reduce the Section 404(b) compliance burden;
- the impact that Section 404(b) compliance costs have on such companies’ decisions to (i) list on U.S. versus foreign exchanges and (ii) engage in IPOs versus other financing alternatives;
- the potential effect that a Section 404(b) exemption would have on the number of such companies listing IPOs in the U.S., and the potential effect that any specific recommendations by which the Section 404(b) compliance burden may be reduced would have on the number of U.S. IPO listings;

CAHILL

- any qualitative differences between subject issuers that might list securities on a U.S. exchange in connection with their IPOs if Section 404(b) remains in effect and subject issuers that might list securities on a U.S. exchange in connection with their IPOs if such companies were exempt from Section 404(b), and any such qualitative differences related to any specific recommendations for reducing the Section 404(b) compliance burden on such companies;
- the potential effect of a Section 404(b) exemption on matters such as: raising capital; engaging in mergers, acquisitions and similar corporate transactions; and attracting and retaining qualified independent directors;
- whether and how the use of the auditor's attestation report on internal control over financial reporting differs for companies with public float between \$75 million and \$250 million from the use of the auditor's attestation report on internal control over financial reporting for issuers whose public float exceeds \$250 million and the reasons for such differences;
- quantitative and qualitative information about whether and how Section 404(b) compliance has benefited investors and other users of financial statements;
- whether and to what extent Section 404(b) compliance enhances confidence in management's assessment of the effectiveness of its internal control over financial reporting, improves the reliability of financial reporting and improves the prevention and detection of fraud and other misconduct;
- any additional information for the SEC to consider to describe the study population and how the SEC could reduce Section 404(b) compliance costs on that population; and
- any other information that the SEC should consider with regard to the study.