REASSESSING SARBANES-OXLEY: THE COST OF COMPLIANCE IN TODAY'S CAPITAL MARKETS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINETEENTH CONGRESS

FIRST SESSION

JUNE 25, 2025

Serial No. 119–31

Printed for the use of the Committee on Financial Services

www.govinfo.gov

U.S. GOVERNMENT PUBLISHING OFFICE
60–990 PDF WASHINGTON : 2025

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REASSESSING SARBANES-OXLEY: THE COST OF COMPLIANCE IN TODAY'S CAPITAL MARKETS

Wednesday, June 25, 2025

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in 2128, Rayburn House Office Building, Hon. Ann Wagner [chairwoman of the subcommittee] presiding.

Present: Representatives Wagner, Hill, Lucas, Sessions, Davidson, Steil, Stutzman, Lawler, Downing, Haridopolos, Sherman, Waters, Scott, Vargas, Casten, Lynch, Fields, and Bynum.

Chairwoman WAGNER. Good morning. The Subcommittee on Capital Markets will come to order.

Without objection, the chair is authorized to declare a recess of the committee at any time.

This hearing is titled, "Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets."

Without objection, all members will have 5 legislative days within which to submit extraneous materials to the chair for inclusion in the record.

I now recognize myself for 4 minutes for an opening statement.

OPENING STATEMENT OF HON. ANN WAGNER, CHAIRWOMAN OF THE SUBCOMMITTEE ON CAPITAL MARKETS, A U.S. REPRESENTATIVE FROM MISSOURI

Good morning again and thank you to our witnesses for being here today. Today's hearing is about making our public markets work again for the companies that fuel our economy, small, innovative firms that want to grow higher and bring new products to market. We are here to examine whether parts of the Sarbanes-Oxley Act, particularly Section 404, are doing more to burden those companies than to protect investors.

When Sarbanes-Oxley, or SOX, was passed in 2002, it had a clear purpose: to restore trust in financial reporting after several major corporate scandals, but more than 2 decades later, it is time to ask whether its most burdensome provisions are still serving investors or merely discouraging companies from ever going public in the first place. For many small companies, Section 404(b) has become a major obstacle. It requires companies not only to assess their own internal financial controls, but also to pay for an external

auditor to effectively repeat that process. That is why many refer to it as a "double audit." The costs can exceed $1 million per year, and even for pre-revenue biotech firms and small cap innovators, these costs do not scale. Again, they do not scale. Whether a company generates $50 million or $5 billion, the compliance checklist is largely the same. For a large company, that may be manageable, but for a startup, it is often the difference between expanding operations or laying off staff.

Compliance costs have not gone down over time. In fact, recent surveys show costs are rising, driving more hours, more documentation, and broader audit scopes. At the end of the day, Main Street investors are footing the bill, whether it is through reduced returns, fewer initial public offerings (IPOs), or the lost chance to invest early in the next great American company. Meanwhile, the benefits are unclear. Internal control weaknesses remain stubbornly high. Many firms only disclose problems after issuing financial restatements. That is not a sign of a healthy system. We have also heard from companies that structure their growth, fundraising, and even equity float to avoid triggering 404(b). That is an indictment of the rule's real-world impact.

Capital formation should not be driven by how to avoid a duplicative audit. A regulatory framework that deters companies from entering the public markets does not strengthen investors' confidence. It weakens long-term economic competitiveness. To be clear, this is not about undermining investor protection. It is about ensuring those protections are effective and proportionate. Congress and the Securities Exchange Commission (SEC) have taken steps to tailor SOX obligations for emerging-growth companies and smaller reporting companies, but the current framework remains overly complex and poorly suited to today's economy, especially for firms that are asset light, IP driven, and increasingly global in structure. Today's hearing is an opportunity to hear directly from the people who live these rules every day. Our job is to ensure that the path to becoming a public company is not paved with unnecessary barriers. Public markets should be open to companies of all sizes, not just those that can afford to navigate an outdated compliance regime.

I would now like to recognize my friend, the ranking member of the subcommittee, Mr. Sherman, for 4 minutes for an opening statement.

OPENING STATEMENT OF HON. BRAD SHERMAN, RANKING MEMBER OF THE SUBCOMMITTEE ON CAPITAL MARKETS, A U.S. REPRESENTATIVE FROM CALIFORNIA

Mr. SHERMAN. Thank you. I believe I am the only one here who is here for——

Voice. Mr. Lucas.

Mr. SHERMAN. Oh, and then Mr. Lucas was also here for Sarbanes-Oxley.

Mr. LUCAS. I was here.

Mr. SHERMAN. And you were here.

Mr. LUCAS. Yes.

Mr. SHERMAN. I am not as old as I think I am. A few of us were here for Sarbanes-Oxley. We remember WorldCom. We remember

Enron and the need for a Public Company Accounting Oversight Board (PCAOB). Even more of us were here for Madoff and the need to apply the PCAOB to broker dealers. We then reformed the PCAOB by making sure that China and Chinese-based companies would be subject to it. That was my bill along with Senator Kennedy, and then we accelerated that process with a separate bill. Then the most recent development was this committee voting to defund the PCAOB, transfer it to the SEC, and not give the SEC any funding or ability to charge fees in order to carry out the functions of the PCAOB. I want to thank the most powerful unknown person in Washington, Elizabeth MacDonough, the Senate parliamentarian, for striking that provision. We should not defund the police in the streets, and we should not defund the police in the suites. That includes the Consumer Financial Protection Bureau (CFPB), and it includes the PCAOB.

The bills that we are considering today include one that would allow auditing firms not to register with the PCAOB but instead, simply meet the standards of the Intergrated Council of Professional Accountants (ICPA). The ICPA was not consulted, the Certified Public Accountants (CPA) caucus was not consulted, and the only standards that would apply to auditing firms were those meeting independence, not those dealing with their competence and breadth of experience for the audit that they were attempting to do. A second bill raises the dollar floor on which companies would be exempt and not have to have reports or as many reports on their internal controls. This makes some sense because we have not adjusted that figure, I believe, since Sarbanes-Oxley. So, if the policy was right then, the dollar amount has to be changed now because $250 million then is very different from $250 million now.

So, I look forward to these hearings and working on these bills. As I said, I think the last time we were all in this room, the most fascinating issues that really the entire country faces are those dealing with auditing and accounting, and they are also the most important issues. So, Sarbanes-Oxley was passed virtually unanimously. We need internal control. We need auditors to audit the internal control, and we need PCAOB to audit the auditors. While this process may be expensive, what is more expensive? An Enron or a WorldCom or both, pretty much at the same time. I think the losses to investors between the two of those were well over $200 billion, but it is not just that. The loss of confidence in our capital markets cost this country even more than the $200 billion to $250 billion lost on those two stocks. I yield back.

Chairwoman WAGNER. I now recognize the chairman of the full committee, Mr. Hill, for 1 minute for an opening statement.

STATEMENT OF HON. FRENCH HILL, CHAIRMAN OF THE COMMITTEE ON FINANCIAL SERVICES, A U.S. REPRESENTATIVE FROM ARKANSAS

Mr. HILL. Thank you, Chair Wagner. I appreciate you holding this hearing. Today we examine the long-term regulatory impact of Sarbanes-Oxley Act of 2002, and while my colleagues may have been here voting for this bill, some of us were in the private sector living under it for the past 20 years. I can tell you our perspectives are quite different, even though we share an important point of

agreement, which is we want investors protected, and we want managements and public companies held accountable, and we want high-quality audit standards, but all that is subject to now looking back 20 years, which is why I think Chair Wagner has done an excellent job in having this hearing.

Implementation of the law, particularly under Section 404(b), is something that is the most expensive feature in our public securities rulebook. Reports show these companies are spending over $1 million a year purely on SOX compliance. So, the fact that we want to take a look at these issues and think through them, I commend the chairwoman, and I yield back the balance of my time.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the ranking member of the full committee, Ms. Waters, for 1 minute for an opening statement.

STATEMENT OF HON. MAXINE WATERS, RANKING MEMBER OF THE COMMITTEE ON FINANCIAL SERVICES, A U.S. REPRESENTATIVE FROM CALIFORNIA

Ms. WATERS. Thank you very much, Chairwoman Wagner. I am pleased that we are holding a hearing to commemorate the Sarbanes-Oxley Act. However, it would have been more meaningful if we could have had this hearing convened before today. Let me just say that the Sarbanes-Oxley Act is the crown jewel of the Public Company Accounting Oversight Board. I have to ask, will what you are doing with this legislation, would it enable paying for a tax cut for billionaires?

Perhaps I can remind you that if you had held this hearing beforehand, you would have realized that the PCAOB is the only regulator that has access to auditors and large public companies in China. Maybe we need to have you think more about realizing that shutting this regulator down does not just hurt U.S. investors, but it helps the Chinese Communist Party. Hopefully, my Republican colleagues are now paying attention. Thank you very much. I yield back.

Chairwoman WAGNER. The gentlewoman yields back. Today we welcome the testimony of Dr. Abigail Allen, Associate Professor of Accounting at the Marriott School of Business at Brigham Young University; and then Mr. Lawrence Cunningham, Director of the Weinberg Center for Corporate Governance at the University of Delaware; Mr. Frank Watanabe, President and CEO of Arcutis; and then Mr. John Coates, a Professor of Law and Economics and Deputy Dean of the Harvard Law School. We thank each of you for you taking the time to be here. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony, and without objection, your written statements will be made part of the record. Dr. Allen, you are now recognized for 5 minutes for your oral statements.

STATEMENT OF DR. ABIGAIL ALLEN, ASSOCIATE PROFESSOR OF ACCOUNTING, MARRIOTT SCHOOL OF BUSINESS, BRIGHAM YOUNG UNIVERSITY

Dr. ALLEN. Thank you. Chairwoman Wagner, Vice Chairman Garbarino, Ranking Member Sherman, and members of the subcommittee, thank you for the opportunity to be here to testify. As

mentioned, I am an Associate Professor at Brigham Young University. I hold a CPA and also a doctorate in business administration. I am here on behalf of myself as well as my co-authors, Melissa Lewis-Western and Kristen Valentine, to testify about the findings from a recent research study that we conducted examining the costs and benefits of Sarbanes-Oxley, and, in particular, Section 404, which deals with the audit of internal controls.

We appreciate the subcommittee's interest in reexamining SOX in today's capital markets, as well as recent initiatives like the 2012 Jumpstart Our Business Startups (JOBS) Act and recent SEC carveouts, which acknowledge that the costs of SOX are not borne equally across all firms. A common thread across regulatory exemptions so far is a size-based litmus test, which recognizes that the direct costs associated with compliance may be overly heavy for small issuers. Our research also speaks to the existence of indirect costs, which manifest for firms of both small and large sizes, so our research focuses on a group of firms that we refer to as young lifecycle-stage firms. These are firms that can be large and high growth but are early in their development as they explore strategic entry into new products or new markets. They invest heavily in research and development (R&D), are not yet profitable from a cash-flow perspective and play a critical role in driving economic growth through exploratory innovation.

Our research suggests that SOX 404(b) had negative consequences for innovation for these firms. Specifically, we find that SOX negatively impacts both the quantity and quality of innovation produced by young lifecycle-stage firms. These firms spend less on R&D, produce fewer patents with lower citation counts. We also find that SOX has negative consequences for the type of research being conducted. Following SOX, young lifecycle firms shift their research pursuits toward safer, less groundbreaking innovation. The patents that they produce are narrower in scope and less likely to lead to future technological advances. Why is that?

Our research identifies two mechanisms through which SOX can harm innovation. The first is resource diversion. Young firms, like small firms, are cash constrained. Every dollar or hour spent on compliance is a dollar or hour not spent on innovation. This same logic, which applies to small firms, is the rationale that motivates current size-based exemptions. The second mechanism is called innovation hindrance. We know SOX imposes centralized control structures, and we believe that sometimes those structures are at odds with the decentralized, flexible environments needed for exploratory innovation. This type of mismatch can stifle the type of risk-taking and creativity that drives breakthrough discoveries for young lifecycle-stage firms.

Importantly, while we document these negative consequences for innovation, we are unable to detect any evidence that the costs are offset by the intended benefits of SOX for these young lifecycle-stage firms. While we do see improvements in financial reporting quality for mature firms consistent with prior literature, we find no evidence that SOX improves financial reporting quality for this subset of young lifecycle-stage firms, no reductions in restatements, no improvements in accrual quality, no gains in future performance. Why? We theorize that these intended benefits do not mate-

rialize for young lifecycle-stage firms because their limited free cash-flow and more concentrated ownership structures lessen the type of agency concerns that financial reporting oversight is intended to mitigate.

Putting these findings together, a clear takeaway from our research is that the impacts of SOX on financial reporting quality and innovation is not uniform. Instead, it varies based on firm-specific characteristics that, in addition to size, may include factors like firm lifecycle-stage and strategic orientation. Accordingly, we advise that any policy solution must involve a complex consideration of both direct and indirect costs against the offsetting benefits by firm type. We also advise that the costs and benefits do not always manifest in the same time period. Like insurance, a regulatory approach that leans toward prevention will necessarily impose heavier costs today in exchange for some presumed security surrounding future financial reporting outcomes. By contrast, relaxing regulations alleviate current cost burdens while increasing future risk associated with remediation.

Our results highlight that the goals of innovation and economic development are not always in contrast, but when they are, policy-based evidence is essential. Thank you for your time.

[The prepared statement of Dr. Allen follows:]

Testimony of Abigail M. Allen, on Behalf of Coauthors

Submitted to the U.S. House Committee on Financial Services, Subcommittee on Capital Markets

Hearing Title: "Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets"

June 25, 2025

Introduction

Chairman Wagner, Vice-Chairman Garbarino, Ranking Member Sherman, and Members of the House Subcommittee on Capital Markets:

Thank you for the opportunity to testify today. My name is Abigail Allen. I am a tenured, associate professor at Brigham Young University. I am also a certified public accountant and hold a Doctorate in Business Administration. I am pleased to provide testimony on behalf of myself as well as my research coauthors, Professors Kristen Valentine PhD (University of Georgia) and Melissa Lewis-Western PhD (Brigham Young University) based on our academic research examining the costs and benefits of financial regulation for public companies.

We appreciate the Subcommittee's interest in re-examining the relative costs and benefits of the Sarbanes-Oxley Act (SOX) in today's capital markets. We also appreciate past initiatives -such as the 2012 JOBS act, and recent SEC rulings- which acknowledge that the costs and benefits of SOX are not equally borne across all firms. A common thread across these regulatory exemptions has been a size-based litmus test intended to reduce the *direct* costs associated with compliance.

Our research demonstrates the existence of important *indirect* costs to financial regulation that may manifest independently from firm size.[1] Specifically, we provide evidence that SOX 404(b), which requires an independent audit of a company's internal controls, may adversely affect both investments in, as well as outcomes for, innovation at young life-cycle stage firms. This is because, in addition to direct implementation costs, SOX imposes top-down governance and control systems which may encumber the decentralized flexible environment required for exploratory innovation. Our findings show that after the implementation of SOX 404(b)—the portion of SOX that requires an audit of internal controls—young life-cycle stage firms invest less in research and development. They also shift toward safer, more

[1] The Innovation and Reporting Consequences of Financial Regulation for Young Life-Cycle Firms, Journal of Accounting Research 60(1), March 2022.

narrowly focused innovation strategies that are less likely to produce broadly applicable breakthroughs.

At the same time, we are unable to find evidence that these firms experience the intended benefits of SOX 404(b) in terms of improved financial reporting. For example, we do not observe meaningful improvements in restatement rates, accrual quality or future performance for young life-cycle stage firms. In contrast, our findings are consistent with other academic studies showing that more mature firms do benefit from the financial reporting improvements that 404(b) aims to deliver.

This raises an important question for policy makers: How should regulators balance the benefits of strong financial reporting oversight with the need to support innovation and growth? Our results do not afford a solution but do highlight the importance of considering a company's developmental stage, in addition to firm size, when assessing the broader consequences and benefits of financial regulation.

To support your deliberations, our written testimony articulates key findings from our own research and briefly summarizes related academic studies. We also present a framework that may assist the subcommittee in assessing the trade-offs between regulatory strategies focused on prevention of financial misreporting versus those focused on remediation, as well as the potential value of targeted exemptions.

Quoting Former SEC chair Mary Jo White (2016) we believe that effective capital markets regulation must satisfy the core mandate to "protect investors" while also "facilitate[ing] capital formation [through] rules and regulatory actions [that] create an environment that foster[s] innovation and growth."[2]

We hope that our testimony is helpful to you in deliberating how to best facilitate these important objectives.

Summary of Our Key Research Findings

Our study examines the differential impact of SOX 404(b) compliance for young life-cycle stage firms relative to more mature firms who implement 404(b) as well as to young life-cycle stage firms exempt from SOX 404(b) provisions.

We define young life-cycle firms as those whose strategic growth priorities require significant capital investments financed through debt or equity issuances and whose operations are not yet profitable. These firms make large investments in R&D, pursue an innovation strategy focused on creating new markets and ideas (termed explorative innovation) and are, accordingly, important for economy-wide growth.

[2] Speech by former SEC Chair Mary Jo White in March of 2016: https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html#_ftn.

Importantly, while often thought of as small startups, young life-cycle firms are frequently large firms and/or high-growth firms that generate substantial innovation and employment opportunities despite having negative operating cash flows. For example, in our event implementation year, young life cycle firms have an average market capitalization of $564M.

Our empirical evidence indicates that:

1. SOX 404(b) negatively impacts both the quality and quantity of innovation produced by young life-cycle stage firms. These firms spend less on R&D and produce fewer patents following 404(b) implementation.
2. Innovation declines are not simply a product of direct implementation costs. After accounting for the magnitude of a company's investment in R&D spending, we demonstrate changes in the type of innovation pursued by young life-cycle stage firms. Our results suggest that this occurs because SOX imposes an organizational culture mismatched to the pursuit of explorative innovation. After SOX 404(b) implementation, young life-cycle stage firms produce patents that prompt less follow-on innovation and are used by a narrower set of future technologies. Moreover, the portfolio of inventions pursued by young life-cycle firms shifts toward safer, lower-risk projects, concentrated in a narrower range of technological fields.
3. Across a battery of tests, we fail to detect evidence of improved financial reporting quality for young life-cycle firms resultant from SOX 404(b) implementation nor do we observe any market-based evidence that other offsetting benefits may compensate for lost innovation.
4. By contrast, our results suggest that mature firms are both less likely to suffer consequences to innovation and more likely to realize improvements to financial reporting quality following SOX.

Understanding the Mechanism:

Our research highlights two primary channels through which financial regulation hinders innovation and explains why the intended benefits to financial reporting regulation are less likely to manifest for young life-cycle stage firms.[3]

Resource diversion – the idea that a dollar spent on compliance is a dollar diverted from alternative investment is often explicitly contemplated by regulators and motivates the existence of size-based regulatory exemptions. Young life-cycle firms are cash constrained relative to their more mature counterparts. Thus, the impact of

[3] For a more detailed treatment of each of these channels including references to related academic research refer to our full paper: The Innovation and Reporting Consequences of Financial Regulation for Young Life-Cycle Firms, Journal of Accounting Research 60(1), March 2022.

SOX 404b compliance costs will have a greater downward effect on the R&D spending and patent outputs of young life-cycle firms relative to their more mature and less cash constrained counterparts.

A key objective of SOX was to ***improve financial reporting quality***. Realized benefits of improved financial reporting quality may outweigh the resource diversion costs to innovation by increasing firms' access to capital. Specifically, financial regulation aims to increase the transparency and accuracy of financial reporting by addressing both the risk of intentional (i.e., fraud) and unintentional (error driven) misstatements. In support of this view, a substantial body of academic research documents a positive relation between financial regulation (or related governance changes), financial reporting quality and investment.

In the context of young life cycle firms, however, the intended benefits of improved financial reporting quality under SOX 404(b) are less likely to manifest for two reasons. First, young life-cycle stage firms have limited free cash flow and more concentrated ownership structures, reducing the agency conflicts that financial regulation aims to mitigate. Second, because a larger portion of young life-cycle firms' valuation stems from intangible investments which are not included on their balance sheet, improving the quality of traditional financial reports may not provide significant benefit to these firms.

Consistent with these differences, our research suggests that young life-cycle stage firms experience more negative consequences for innovation without receiving corresponding financial reporting benefits from the implementation of SOX 404(b).

Innovation hindrance captures the idea that internal controls regulation may impose an organizational environment which is less conducive to explorative innovation. Innovation requires companies to invest in long-term risky projects (e.g., R&D) that often require substantial coordination and are facilitated by a decentralized decision-making process that emphasizes strategic objectives rather than financial controls. Essentially, innovation-fostering environments encourage employees to focus on longer-term strategic objectives that lead to innovation rather than on short-term quantifiable performance. This structure facilitates innovation by allowing the employee to make decisions quickly and independently, and by encouraging longer-term focus and risk taking. Because numerous aspects of financial regulation aim to increase centralization of decision making and formalization of rules, processes, and communications, they may negatively impact both the quality and quantity of explorative innovation.

We theorize that young life cycle stage firms are more vulnerable to innovation hindrance from SOX 404(b) based on their higher propensity to engage in explorative innovation directed at new products and customers. Explorative innovation thrives in an environment that promotes non-routine problem solving and deviance from existing knowledge or processing. To the extent that young life-cycle firms' explorative innovative activities require a creative environment where investigation and failure can quickly occur, increased centralization of decisions and elevated controls are likely to hinder the exploration process, thereby reducing the quality and quantity of explorative innovation.

By contrast, mature firms often leverage existing technology and firm product lines to achieve incremental improvements for its existing customer base, known as "exploitative innovation". As exploitative innovation relies on existing processes and structure, centralization of control and formalized processes, rules and communication channels may serve to increase exploitative innovation. Thus, compared to their younger counterparts, mature life-cycle firms are less likely to suffer innovation consequences from financial regulation.

Our results confirm that SOX 404(b) impedes the innovation activities of young life-cycle stage firms. The decline in innovation extends beyond reductions in R&D spending that may reflect a direct reallocation of resources toward SOX 404(b) compliance. Consistent with the view that internal control mandates reshape the innovation environment, we find evidence that following the implementation of SOX404(b), young life-cycle firms not only produce fewer patents, but the patents they do generate are less risky, concentrated in fewer technological domains and lead to less future innovation with narrower application.

Summary of Prior research examining costs and benefits of SOX

A substantial body of academic research has examined the costs and benefits associated with SOX. In their 2014 multidisciplinary review, Coates and Srinivasan (2014) evaluated the consequences of SOX by analyzing over 120 studies spanning the fields of law, accounting, and finance. Below we provide a brief summary of key findings from their review as well as for selected publications which post-date that review. Our objective in providing this summary is to highlight the potential tradeoffs that may be relevant to the subcommittee in contemplating regulatory changes.

Key Costs and Benefits of SOX for public firms

An inherent difficulty in measuring the net impact of any regulation is that the effects of regulation are rarely uniform across firms. Additionally, while academic research may often illuminate individual effects – it is difficult for a single study to examine all

of the costs and benefits collectively in a manner that would allow for a comprehensive cost benefit evaluation. Reflecting this difficulty, Coates and Srinivasan (2014) conclude that the mixed evidence from academic studies does not support a definitive assessment of the law's overall net impact. Specifically, while direct compliance costs – particularly during initial implementation – are more easily measured, they note that indirect costs like changes in firm behavior or market dynamics are harder to quantity. Likewise, the benefits of SOX – such as enhanced investor confidence and improved financial reporting are more difficult to measure.

The following table summarizes the key categories of costs and benefits to public companies from implementing SOX that have been documented by prior research as summarized by Coates and Srinivasan (2014) and subsequent writings, alongside citations to selected illustrative studies.[4]

Table 1: Key types of Costs and Benefits to SOX as documented by prior research.

Costs to Companies	Benefits to Companies
Direct Implementation Costs • Coates 2007, • Cox 2013, • Alexander, Bauguess, Bernile, Lee, and Marietta-Westberg 2013.	**Lower Rates of Restatements** Illustrative References: • Burks 2010, • Burks 2011, • Hennes, Leone, and Miller 2008.
Direct Litigation Costs Illustrative References: • Brochet and Srinivasan 2013, • Linck, Netter, and Yang 2009.	**Higher-quality Financial Information** Illustrative References: • Cohen, Dey, and Lys 2008, • Ge, Koester, and McVay 2017, • Feng, Li, and McVay 2009.
Indirect Costs from Changes in Investments Illustrative References: • Albuquerque and Zhu 2013, • Allen, Lewis-Western, and Valentine 2022, • Bargeron, Lehn, and Zutter 2010, • Greenspan 2003, • Kang, Liu, and Qi 2010.	**Improved Audit Quality** Illustrative References: • DeFond and Lennox 2011, • DeFond and Zhang 2013.

[4] References in this table are for illustrative purposes and capture only a subset of the large body of academic writings examining each of these costs/benefits. For a fuller listing of related research refer to Coates and Srinivasan (2014).

Researchers have also attempted to measure the net costs/benefits of regulation to companies as perceived by investors through analyses of market data. For example, several early studies examined investor reactions to key legislative dates surrounding the passage of SOX, with mixed findings.[5] Conceptually, these estimates will account for investors' collective wisdom with respect to firm value but are unlikely to capture positive market-wide benefits such as enhanced trust in the capital markets overall.

Another method to judge firms' own perceived costs of SOX compliance is to identify how much of their market valuation firms are willing to sacrifice in order to avoid having to comply with SOX. More recently, researchers have estimated the net economic costs imposed by financial regulation by examining firms' tendency to manage their public float downward to avoid exceeding the $75 million and $700 million regulatory market capitalization thresholds. Firms revealed preferences to stay below regulatory thresholds suggest *net* compliance costs of 1.8% of a companies' market capitalization for firms around the initial $75M SOX 404(b) threshold and 1.8% for firms around the $700M emerging growth company (EGC) threshold created by the 2012 JOBS act.[6] These negative net cost estimates can provide useful inputs for regulatory comparison against potential broader market or social benefits, though again, firms' own assessments are unlikely to consider the importance of any market-wide benefits.

The influence of SOX on the composition of US public firms

A persistent concern among policymakers and market participants is that the increased costs associated with SOX compliance may have negative implications for participation of firms in U.S. capital markets. Specifically, the high costs associated with being a public company may discourage companies from pursuing initial public offerings (IPOs) or may induce higher rates of going private or deregistering securities from US stock exchanges (hereafter delisting) amongst already public firms. Below we highlight some academic literature which explores these concerns.

Do SOX requirements increase rates of public firm delisting?

Empirical studies consistently find that smaller, less liquid firms with lower-quality financial reporting were more likely to delist in the years following SOX.[7] While these patterns raise valid concerns about the cost burden for smaller firms, they also

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[5] See for example Zhang (2007), Leuz (2007), Jain and Rezaee (2006), Iliev (2010).

[6] Specifically, Ewen, Xiao, and Xu (2024) utilize firms strategic bunching just beneath regulatory exemption thresholds to infer the implied costs of regulation. Translated into doll, annual regulatory costs of $0.132M associated with SOX 404 compliance and accelerated filing and of $0.87 million per year associated with losing EGC benefits (pg. 13).

[7] Engel, Hayes, and Wang (2007); Kamar, Karaca-Mandic, and Talley (2009); Leuz, Triantis and Wang (2008).

suggest that SOX may have initially improved the overall quality of firms remaining in public markets. The net social benefit or cost of these exits remains debated, but the evidence indicates that SOX may have prompted greater scrutiny of firms' suitability for continued public listing.

More recent research fails to find evidence that regulatory costs imposed by SOX continue to significantly influence firms going private decisions.[8] Researchers conjecture that this may be explained by the fact that some of the regulatory costs are irreversible after initial implementation.

Do Private Firms Forgo or Delay IPOs because of SOX?

Initial research examining the impact of SOX on firms' IPO decisions yielded mixed results. Early evidence argued that declining IPO rates amongst small firms were an effect of SOX.[9] Subsequent research, however, demonstrated that the declining IPO rates were due to pre-existing trends and not SOX itself. Furthermore, declining IPO rates were largely unaffected by the 2012 JOBS act exemptions.[10] Consistent with the idea that SOX increased the quality of publicly listed firms, there is evidence suggesting that IPO pricing improved after SOX, implying a lower cost of capital for firms that choose to go public.[11]

More recent research finds evidence that regulatory compliance costs can have significant effects for firm IPO decisions. The authors of a recent study estimate that a one-standard deviation increase in regulatory costs is associated with a 6.5% decrease in IPO likelihood. Notwithstanding, this same study estimates that the effects of SOX specifically have been limited relative to other concurrent trends. By their estimates, removing SOX might change the annual IPO volume by only 0.01% because many IPO candidates will fall below existing SOX exemption thresholds.[12]

Placing our study into the context of prior research

Our results point to life-cycle stage as an important factor to consider when assessing the costs and benefits of financial regulation. Specifically, we observe that SOX did not lead to improvements in the quality of financial information for firms in the early stages of their life cycle. In contrast, more mature firms experienced a decline in financial restatement rates, suggesting improved reporting accuracy. Our findings further demonstrate that SOX has distinct negative effects on innovation for firms in the early stages of their life cycle which are distinct from the effects of firm size.

[8] Ewens, Xiao and Xu (2024).
[9] IPO Task Force 2011, Bova, Minutti, Richardson and Vyas (2013).
[10] Gao, Ritter and Zhu (2013), Doidge Karolyi and Stulz (2013).
[11] Johnson and Madura (2009).
[12] Ewens, Xiao and Xu (2024).

Descriptively, we also find that firms in the early stages of their life cycle are more likely to delist following SOX compared to more mature firms.[13]

Overall, these results underscore the importance of considering a company's developmental stage when evaluating the broader consequences of financial regulation on firm outcomes.

Policy Implications

A clear takeaway from our research is that the impact of SOX on financial reporting quality and innovation is not uniform. Instead, it varies based on firm-specific characteristics, particularly life-cycle stage which are not fully captured by existing size-based exemption thresholds. To provide context, we examine public firms incorporated in the U.S. with available data to determine their life-cycle stage during recent years (2020 to 2024). These data suggest that on average one one-fifth of current public firms are young-life cycle stage.[14]

The following summary statistics from 2020-2024 show the proportion of these young life-cycle stage firms that would not qualify for exemption from SOX 404(b) based on current cutoffs for non-accelerated filer status.

[13] Delisting is not the focus of our paper and unlike our primary tests establishing the effects of SOX for innovation, our evidence on delisting should not be interpreted as implying a causal relationship. Notwithstanding, we believe these results provide an important counter-perspective to prior literature. While prior research suggests that delisting is more prevalent amongst firms with weak disclosure practices or poor management, our findings suggest a different narrative: for young, innovation-focused firms—often operating with limited resources—exiting the public market may be the most viable strategy for preserving their ability to invest in long-term innovation.

[14] Out of 23,550 firm-year observations covering the 5-year window of 2020-2024, 20.34% (4,790) firm-years are classified as young life-cycle firms while the remaining 79.66% (18,760) are in other life-cycle stages.

Table 2: Young Life-Cycle Firms by Filing Status 2020-2024

Status	**Public Float**	**Annual Revenue**	**Percentage**
Smaller Reporting Company (SRC) and Non-Accelerated Filer	Less than $75M	Any	40.10%
	$75M to less than $700M	Less than $100M	26.10%
Total % of young life-cycle stage firms exempted from 404(b)			**66.20%**
SRC and Accelerated Filer	$75M to less than $250M	$100M or more	3.76%
Accelerated Filer (not SRC)	$250M to less than $700M	$100M or more	5.11%
Large Accelerated Filer (not SRC)	$700M or more	Any	24.92%
Total % of young life-cycle stage firms not exempted from 404(b)			**34.8%**

Our research suggests innovation consequences for young life-cycle stage firms not exempted from SOX 404(b) do not appear to be offset by improvements to financial reporting quality. However, as highlighted in our review of prior literature, there are also a host of additional indirect costs and benefits to regulation which may vary across firm types and are relevant to any policy discussion of net effects.

The goal of our written testimony is to clearly articulate the boundaries of our own knowledge informed by research and then allow the democratic process to make decisions about which benefits are worth attempting to achieve via legislation considering the associated costs. Consistent with sentiments expressed by the economist Thomas Sowell, in complex settings like the U.S. capital markets, we believe there are no right answers, only tradeoffs.[15]

In the next section we provide a framework that we hope will be useful to the subcommittee as it deliberates these important tradeoffs.

[15] Thomas Sowell, "A Conflict of Visions: Ideological Origins of Political Struggles" (1987)

Key Tradeoff: Prevention versus Remediation

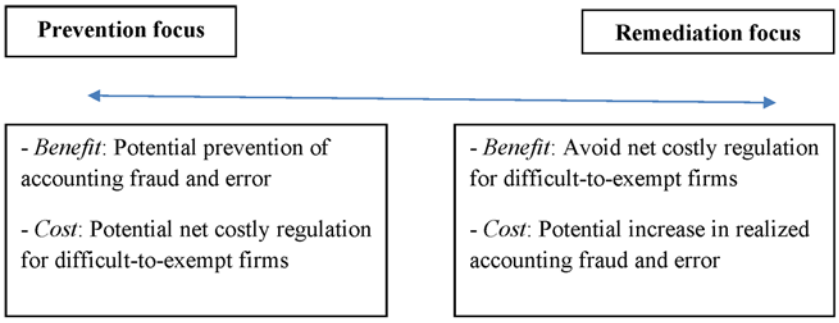
In our view, a key choice when considering adjustments to SOX is how much to emphasize ***prevention*** of accounting fraud and error relative to ***remediation*** in the event fraud and error occur. When functioning at its best, a system of governance and controls can prevent accounting fraud and error, engendering trust in the capital market system. But as our research and other studies have shown, a uniform focus on prevention may impose significant burdens on at least a subset of regulated firms for whom the costs do not outweigh the benefits.

On the other side of the spectrum, failure to prevent accounting fraud and error means that remediation steps become necessary. The loss of public trust in capital markets is difficult to quantify, and the extent to which fraud and error might increase if preventative systems are weakened is inherently uncertain.

This ambiguity complicates cost-benefit assessments for policymakers. A greater focus on remediation may help avoid imposing unnecessary costs on some firms, but also engenders greater risks related to systemic accounting fraud and error.

Importantly, these are not binary choices but points along a continuum, as illustrated in the following figure.

Figure 1: Benefits and Costs of Prevention-Focused versus Remediation-Focused Financial Regulation



Policy makers may choose different positions along this spectrum depending on the characteristics of specific groups of firms. For example, the JOBS act of 2012 established the Emerging Growth Company (EGC) designation, which exempts qualifying firms from SOX 404(b) for up to 5 years post IPO. The intent of such regulatory relief was to reduce compliance costs and encourage increased public

offerings and job creation. Similarly, the SEC's 2020 amendments to the definitions of accelerated and large accelerated filers introduced a carve-out for smaller reporting companies (SRCs) with less than $100 million in annual revenue, exempting them from SOX 404(b) even if they otherwise meet the public float criteria for accelerated filer status. These changes reflect a recognition that the costs of auditor attestation may outweigh the benefits for certain low-revenue firms, where the risk of material misstatement is lower.

Regulatory exemptions are typically predicated on size-based thresholds. Our research highlights the importance of considering a company's stage of development —alongside its size— as a factor in regulatory cost-benefit analysis. However, we acknowledge that such designations may be more difficult to implement in practice than are size-based exemptions.

Additionally, an important consideration for any policy application of academic findings, including ours, is an understanding of how empirical results from prior periods may generalize to the present environment. We accordingly conclude our testimony below with a discussion of key factors that we believe warrant careful consideration as the subcommittee evaluates the implications of prior academic research for current policy making.

Key Considerations: Applying academic studies to regulatory deliberations.

Our testimony has highlighted a large volume of interdisciplinary research, including our own, which points to important costs and benefits that we believe are relevant to current policy conversations surrounding SOX. An important caveat is that the empirical evidence from most prior research is necessarily limited to a now historical timeframe. A key question is to what extent the documented costs and benefits of SOX remain relevant for policymakers evaluating prevention versus remediation strategies today.

In our view, theoretical insights from well-designed academic research are more likely to generalize than the specific cost-benefit estimates found in any single study. Additionally, we encourage policymakers to consider the following three factors that may nuance the applicability of research studying the implementation of SOX in the early 2000s to the U.S. capital markets today:

1) The pace of technological change,
2) changes in composition and characteristics of public firms, and
3) the impact of deregulation versus introducing new regulation.

First, ***technological advancements*** – particularly in financial reporting – have significantly transformed corporate accounting systems. When functioning well, automated accounting systems can be an important part of a system of internal controls that prevent or detect misstatements before financial statements are issued as well as increase the efficiency of the reporting system. At the same time, widespread automation of processes may heighten the potential risk of systemic errors. In manual systems, internal control failures may affect only a limited number of transactions. In contrast, failures in automated systems can propagate across large volumes of data. More research is needed to understand how these changes will influence the risk of financial reporting errors and the effectiveness of financial regulation relative to time periods with less access to technology.

Second, the ***composition and characteristics of publicly traded firms has evolved*** since the early 2000s alongside the broader U.S. economy. While academic studies typically report average effects for a population, group averages may obscure important differences across firm types. Academic research is effective at quantifying average effects for a particular population, but these effects may manifest differentially for individual firms. Likewise, how different firms respond to incentives may shift in response to a changing economic environment. Accordingly, as the global competitive landscape and nature of firms continues to evolve historical average effects may no longer reflect current realities.

Third, ***the costs associated with SOX implementation may not be fully reversible*** through deregulation. For incumbent public firms, the initial costs of establishing internal control audits have largely been absorbed, leaving only ongoing maintenance costs as potentially recoverable through deregulation. Moreover, if SOX induced persistent changes to corporate compliance culture which are detrimental to risk taking and innovation, that culture may persist even if regulatory requirements are relaxed, thereby limiting the potential benefits of repeal. However, newly public firms exempted from full SOX compliance could avoid initial implementation costs and may benefit from a regulatory approach that appropriately balances prevention and remediation.

Concluding remarks

Collectively, our research as well as that of prior scholars highlights the need for careful consideration of both the direct and indirect costs to regulation. We emphasize that the net benefits of regulation are often not distributed uniformly. In considering such tradeoffs we do not propose a solution, rather we advise strategic deliberation that weighs the costs and benefits from a prevention versus remediation focused policy depending on the nature of the firm.

We appreciate the opportunity to submit testimony and hope our understanding can help to frame the subcommittee's decision analysis and facilitate informed debate on the tradeoffs inherent in capital markets regulation. We are happy to provide additional testimony if we can be helpful to you in the future.

Chairwoman WAGNER. Thank you. Mr. Cunningham, you are now recognized for 5 minutes for your oral statement.

STATEMENT OF MR. LAWRENCE CUNNINGHAM, DIRECTOR, WEINBERG CENTER FOR CORPORATE GOVERNANCE, UNIVERSITY OF DELAWARE

Mr. CUNNINGHAM. Chair Wagner, Ranking Member Sherman, committee members, thank you for the opportunity to testify today. It is an honor to be here. I am Lawrence Cunningham, Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. I have been writing about Sarbanes-Oxley—SOX—since its inception and ever since, carving a niche in the legal academy at the intersection between law and accounting. SOX was an effective congressional response to several massive frauds. It restored investor confidence at a critical time and helped deter earnings manipulation, but over time, it became clear that SOX missed its mark in important ways, channeling excessive resources into internal controls at the expense of financial reporting.

Let me stress this core insight. Compliance is not the same as accuracy. A company can have strong internal controls and still misreport its financials or weak controls and report accurately. Yet, SOX treats internal controls as equivalent to financial reporting, as if they are the goal rather than the means. Over 2 decades, SOX has fostered a sprawling compliance industry where controls proliferate, and auditability of controls becomes more important than utility. The system often prizes procedural auditing checklists over substantive accounting judgments. That is why, despite SOX, financial restatements persist, including recently at marquee companies like CSX, Archer Daniels Midland, and Macy's. Last year saw the most reissued financials in many years, and over the past decade, internal control reports flagged fewer than a quarter of the issues in advance. They have become postmortems, not early warnings.

The costs are real. SOX imposes fixed costs that hit small firms the hardest. The average is $1.5 million per year, with a quarter of companies paying more than $2 million. For small firms, from biotech companies to regional banks, that is money not invested in R&D, employee hiring, training, growth, and other important business matters, and the impact on capital markets is pretty clear, too. SOX contributed to a sharp drop in the number of public companies, from 6,500 or so back then to around 4,000 today, even as the number of large private companies has grown dramatically. Nordstrom and Walgreens are just two of the companies recently indicating they prefer to be private than public, underscoring the costs. Investor perspectives are divided. Many investors believe that the external audit of internal controls adds little or no value. That is especially true of the long-term focused investors who prefer to do their own analysis. On the other hand, some support the audit of internal control, especially the index fund community that does not conduct firm-specific analysis, but that division underscores the need for flexibility in this area.

Congress has modernized every other major securities law. SOX deserves the same reassessment and reform. The reform should focus on three things: first, to reinforce the primacy of financial

statement reporting over internal control; second, focus audit standards on judgment and substance, not process and system; and third, tailor compliance to risk. Let us reaffirm that the North star of our capital markets is accurate financial reporting, not well-documented internal controls. The two pending bills are a good step in that direction.

Thank you. I look forward to your questions.

[The prepared statement of Mr. Cunningham follows:]

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TESTIMONY

REASSESSING SARBANES-OXLEY: THE COST OF COMPLIANCE IN TODAY'S CAPITAL MARKETS

Lawrence A. Cunningham
Director
John L. Weinberg Center for Corporate Governance
University of Delaware

Before the U.S. House Committee on Financial Services
Subcommittee on Capital Markets

2128 Rayburn House Office Building
June 25, 2025

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EXECUTIVE SUMMARY

Key Findings

Compliance ≠ Accuracy. Effective internal controls do not guarantee accurate financial reporting. A company can have weak controls and clean financials—or strong controls and misstatements. Yet the Sarbanes-Oxley Act of 2002 (SOX) elevates internal control audits to a status equivalent to financial audits, often blurring that distinction.

Form over Substance. SOX created a regime where internal controls may be optimized for auditability rather than effectiveness. This has institutionalized a culture of documentation and testing that can distract from the ultimate goal: the fair presentation of financial results.

Persistent Restatements. While restatements surged after SOX's enactment, declined, and then surged again, they remain common. This pattern suggests that SOX has not materially reduced reporting errors—and may, in some cases, contribute to them by diverting attention to form over substance.

Distorted Capital Formation. Since SOX, the number of public companies is down almost half while large private companies have grown sixfold. Regulatory costs, particularly Section 404(b), are among the contributors to this shift—deterring initial public offerings (IPOs), prompting exits, and burdening small firms disproportionately.

Unequal Investor Value. Sophisticated and active investors often view SOX disclosures as duplicative or irrelevant, while passive investors rely on them as system-level guardrails. Yet companies—and ultimately their employees and active investors—bear each firm's cost of maintaining these guardrails.

Recommendations

Support Bills. Advance proposals to revise the Section 404(b) thresholds for low-revenue issuers and to clarify auditor independence rules for pre-IPO companies. Both bills reflect a more proportionate, risk-based approach to oversight and would relieve unnecessary compliance costs without weakening investor protection.

Tailor Compliance to Risk. Replace blunt, size-based thresholds with a risk-based framework that better aligns audit intensity with risk exposure.

Rebalance Audit Priorities. Reinforce the primacy of financial statement accuracy over formal control attestations. Officer certifications and board oversight should carry more regulatory weight than audit boilerplate.

Refocus the Compliance Framework. Encourage regulators and standard setters to shift from procedural checklists toward professional judgment and substantive accountability.

Conclusion

SOX was a prompt and effective response to corporate scandals, but it has ossified into a costly compliance architecture that too often prioritizes process over performance. A targeted, evidence-based reassessment—especially of Section 404(b)—is overdue. Congress has modernized every major securities law; SOX deserves the same attention. The goal is not to weaken investor protections, but to strengthen them by restoring the primacy of accurate financial reporting as the North Star of our capital markets.

I. INTRODUCTION

Chair Wagner, Ranking Member Sherman, and members of the subcommittee, thank you for the opportunity to testify at this important hearing on the Sarbanes-Oxley Act of 2002 (SOX). I understand that this hearing is being held to examine how SOX has affected public companies and capital formation, particularly with respect to compliance burdens, audit requirements, and internal control attestations under Section 404(b). I have been informed that the Committee is especially interested in understanding whether certain provisions of SOX have outlived their original purpose or unintentionally discourage companies from going or staying public.

I am Lawrence A. Cunningham, the Director of the University of Delaware's John L. Weinberg Center for Corporate Governance, and have decades of experience in corporate governance and financial reporting.[1] I have been a tenured professor at top universities; served on public company boards and advised others; authored a widely adopted textbook on accounting, finance, and auditing for lawyers; and written extensively on these subjects, including influential articles on SOX and internal controls over financial reporting (ICFR) (excerpts from which appear in the Appendix hereto).[2] Earlier in my career, I served on the staff of the short-lived Independence Standards Board and submitted a comment letter on the first auditing standard under SOX proposed by the Public Company Accounting Oversight Board (PCAOB).[3]

My testimony focuses on the compliance and audit requirements of Section 404, including the 404(b) mandate for independent attestation of ICFR and their effects on public companies, capital formation, and investor outcomes. While SOX was a voluminous bill, these were by far the most consequential provisions;[4] many others were incidental, ineffective, or superfluous.[5]

One core insight I offered in my early analysis of SOX, and one that has proven more salient over time, is that the statute shifted the focus of financial reporting from a primary emphasis on the substance of disclosures to an equal emphasis on the form of control compliance.[6] Over two decades, SOX has fostered a sprawling compliance infrastructure in which internal controls come to be inadvertently designed for auditability rather than effectiveness.[7] This culture risks prizing documentation over discernment, checklists over judgment, and dilution of professional skepticism.[8]

That structural shift, reinforced by auditor incentives and regulatory expectations, helps explain why financial report restatements remain common and why financial reporting quality has not improved in proportion to the compliance effort. In this testimony, I explore the causes, consequences, and potential remedies for this shift.

II. CONTEXT

SOX replaced a decade of incremental reforms with a sweeping federal overhaul in response to the collapses of Enron and other corporate giants that shattered investor confidence. It imposed new obligations on executives, auditors, and directors and created the PCAOB to police audit firms.

Yet SOX did not arise in a vacuum. During the 1990s, the Securities and Exchange Commission (SEC) had already begun tightening the system—Chairman Arthur Levitt's "Numbers Game" campaign targeted earnings manipulation; a 1999 Blue Ribbon Committee spurred the NYSE and NASDAQ to require independent, financially literate audit committees; and the Auditing Standards Board issued guidance to strengthen auditor–committee dialogue. These were incremental, tailored reforms.

In the public panic after Enron, Congress replaced that measured trajectory with a one-size-fits-all regime. Passed at speed, SOX layered uniform mandates onto companies of every size and sector—an extraordinary breadth that has endured for twenty-three years. The question now is whether those laws are effective today.

When he was an SEC Commissioner, current SEC Chairman Paul Atkins observed that Section 404 is SOX's "most controversial provision."[9] Section 404(a) requires management to establish and maintain internal control over financial reporting (ICFR) and to include in the company's annual report a written assessment of ICFR effectiveness. Section 404(b) requires a registered public accounting firm to attest to and report on that assessment.

While ICFR tools and practices long pre-dated SOX, these attestation requirements significantly increased the required investment and cost of maintaining them with a one-size-fits-all set of mandates that were invariant to the diversity in size and complexity of the thousands of companies affected.

SOX imposed enhanced independence requirements for external auditors, including restrictions on the types of non-audit services they may provide to their audit clients. These restrictions curtailed longstanding practice of accounting firms offering consulting services—such as financial information systems design or internal audit outsourcing—to audit clients. While these limitations reduced certain lines of business for audit firms, SOX created entirely new and very lucrative lines to replace that lost revenue.[10]

SOX introduced a dual-reporting regime that combines the traditional audit of financial statements with an audit of ICFR. While ICFR is intended to support the reliability of financial reporting, it is not determinative. A company can receive an unqualified opinion on its financial statements even if its internal controls are found to be ineffective, and conversely, it can have effective internal controls while its financial statements contain material misstatements.

These realities reflect the fact that effective internal control, while important, is neither a necessary nor sufficient condition for financial statement accuracy. The integration of these two audit components can obfuscate their respective purposes, but for financial analysis, it is the fair presentation of the financial statements that ultimately matters.[11]

Moreover, compliance has been vastly more expensive than anticipated, especially the auditor fees. Given the high fixed costs involved, smaller companies face disproportionately large costs.[12] Repeated efforts have been made to make this fairer and more rational, including exempting companies that fall below certain size metrics designated as "smaller reporting companies" and "emerging growth companies."[13] As a result, while all companies must comply with 404(a)'s officer certifications, a majority of public companies are exempt from 404(b).[14]

Despite these changes and exemptions, the auditing of ICFR remains a central element of the post-SOX framework and is treated as a functionally co-equal component alongside the audit of financial statements.[15] This structural elevation of ICFR continues to shape compliance and oversight practices and warrants reexamination.

III. BENEFITS

SOX was enacted with the promise of strengthening financial reporting through a host of reforms. Some of its achievements are clear and commendable. Yet the overall record is, at best, mixed—and the path to those benefits has often come at a steep price. This section examines the intended gains and the difficulties in realizing them, while a fuller accounting of costs follows in

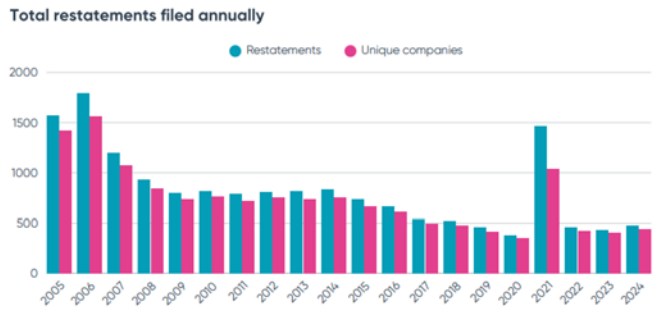
the next section.

A. Restatements

An accounting restatement occurs when a company corrects previously issued financial statements. Corrections can arise from mistakes, fraud, or changes in accounting rules or interpretations. Restatements are typically made when the original financial statements are found to be materially inaccurate and could mislead investors.

Restatements reflect the quality of financial reporting. A high number or frequency of restatements may indicate weaknesses in accounting practices, internal controls, or oversight processes. As such, restatement patterns are often used to evaluate the reliability and quality of financial reporting.

Restatements surged after SOX, peaking at 1,788 in 2006, and while they declined thereafter, they never vanished—and are rising again.[16] In 2024, public companies disclosed 479 restatements, up 10% from the prior year and more than 25% from 2020.[17] (Figure 1 below.) The average restatement cited two issues—the most since 2007—and over half affected net income or retained earnings, 65% negatively. High-profile companies like Archer Daniels Midland, Macy's, and CSX were among those restating.[18] The leading issues included debt and equity accounting, revenue recognition, and liability estimates, underscoring the persistence and complexity of financial reporting errors even two decades after SOX.[19]



Source: Audit Analytics, Financial Restatements (June 2025)

A plausible reason for persistent restatements is that SOX focuses at least as much attention on internal controls as on the financials themselves—controls that companies rightly design to prevent material errors but that auditors must also document for attest purposes. Over time, such an emphasis can shape a compliance culture preoccupied with testing and documenting controls—often at the expense of analyzing or improving the quality of the financial disclosures.

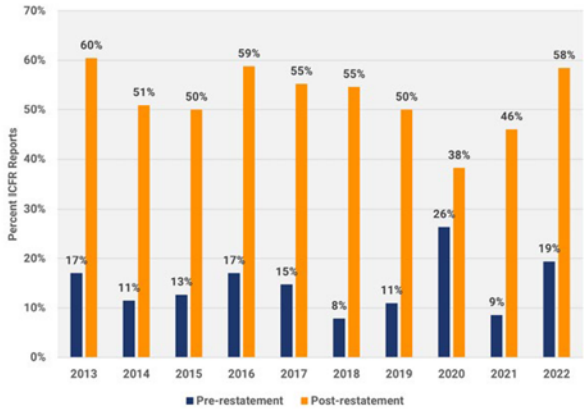
B. Early Warning System

The elevation of control testing was intended to create an early warning system in which weaknesses in controls would signal risk of financial misstatements. But there is evidence of a disconnect between ICFR and financial reporting. For example, an early study found that while 733 companies had reported material ICFR weaknesses through 2006, only 59% of those corrected

the problems during the first year after reporting them and 30% kept reporting the same weakness three years later.[20] The disconnect is clearer from a study showing that a majority of companies don't disclose material ICFR weaknesses until after they issue a restatement of its financial report.[21]

Practitioners report a practical side-effect: because audit firms were required to document and test controls exhaustively, engagement teams sometimes spent less time probing complex accounting judgments—the very issues that often trigger restatements. The emphasis on control documentation diverts scarce auditor hours away from higher-value technical analysis. PCAOB inspection cycles compound the problem: partners frequently address prior-year control questions in the middle of current-year quarter-end and year-end work, pulling attention from live reporting issues. These examples illustrate how a well-intended focus on controls can unintentionally crowd out the substantive accounting scrutiny that investors ultimately rely on.

The Center for Audit Quality recently found that management's internal control reports rarely identify the accounting issues that later lead to restatements.[22] In fact, during the period from 2013-2022, only 8–26% of ICFR reports preceding a material restatement cited the relevant issue, while 50–60% did so only after the fact.[23] (Figure 2 below.) This suggests that internal control attestations, while well-intentioned, often fail to serve as early warnings. Instead, they function more as post-mortems—confirming what went wrong, rather than helping to prevent it from occurring. This reinforces the need to refocus SOX more on the accuracy of reported numbers, not the auditability of controls.



Source: Center for Audit Quality (June 2024)

Leading audit firms such as EY and Deloitte emphasize that ICFR audits provide distinct and valuable assurance—particularly in identifying control weaknesses that may not surface in a financial statement audit.[24] They caution that investors should not infer control effectiveness from a clean financial audit alone. Yet in doing so, they underscore the very concern at the heart of this testimony: that internal control audits have been elevated to a status that rivals, and sometimes overshadows, the audit of the financial statements themselves. Even as these firms defend the value of ICFR audits, they acknowledge the complexity, cost, and potential for investor confusion—

reinforcing the need to rebalance our regulatory framework to prioritize the accuracy of reported results over the auditability of internal processes.

C. Reporting Quality

Material weaknesses in ICFR are associated with low quality financial reporting,[25] larger abnormal accruals,[26] greater likelihood of restatements, less accurate forecasts, and lower earnings quality.[27] Some even see weak ICFR as a warning sign of fraud.[28] In theory, therefore, prompt disclosure of ICFR weaknesses could improve the quality of financial reporting and help investors.

Whether the theory works in practice is hard to determine. For one, any observed improvements post-SOX may be due to other SOX reforms, including strengthened audit committees or the officer certifications, which were intended to produce the same benefits and appear to do so more effectively given that such officers rather than auditors are typically the bad actors.[29]

Observed data suggests reporting quality rising and falling over time. For example, the number of adverse 404(b) reports rose to a peak of 480 by 2005, gradually declined to 139 in 2020, then rose again to peak at 246 in 2019.[30] The aggregate number of adverse 404(a) assessments rose from 16.5% in 2007, peaked at 23.9% in 2014 and fluctuated in the low 20s since. For the subset of companies exempt from 404(b) the figures were higher, rising from 27.4% 2007, peaking at 42.4% in 2014 and fluctuating in the high 30s and low 40s thereafter. Such figures do not support the theory that control audits improve financial reporting quality.

D. Earnings Management

Perhaps the area where SOX's greatest success was achieved is earnings management—the manipulation of accounting policies to present desired reporting results.[31] For example, one study segmented firms just above and just below the 404(b) compliance breakpoint finding those subject to 404 to have lower discretionary and total accruals than those exempt.[32] Another found that earnings quality increases after a company corrects a material weakness that 404 prompted disclosing.[33] This success was greatest in SOX's earliest years, when earnings management appeared to decline.[34] In its later years, the evidence is mixed.[35] Earnings management, even under SOX, varies with factors ranging from the CEO's tenure and risk outlook to a company's share buyback practices.[36]

IV. COSTS

The burden of SOX compliance—especially under Section 404(b)—is both heavy and growing. Direct costs are high and rising: building control systems, documenting them, testing them, and paying external auditors to attest to them. Indirect costs are harder to quantify—and likely higher still.

A. Direct Costs

In the early years after its passage, implementing SOX cost larger companies an average of $7.3 million and smaller ones an average of $1.5 million.[37] Ongoing compliance costs trended lower by between 16% and 31%, since some initial costs were one-time events and the learning curve flattened.[38] However, in subsequent years and recent ones, costs have tended to increase and continue to do so, with recent average annual budgets of $1.6 million and 11,800 hours spent.[39] (Figure 3 below.)

Source: KPMG (2023)

Protiviti reports annually on SOX compliance costs. Average costs rose from $1.338 million in 2016 to $1.339 million in 2018;[40] hours and effort had not decreased significantly between 2009 and 2019;[41] and cost, hours and effort rose through 2022.[42] Average costs remain high at around $1.5 million with a quarter of companies paying more than $2 million and only a quarter or less incurring costs below $500,000.

Small companies remain disproportionately burdened: the larger companies (float > $10 billion) face average costs of $2 million while smaller ones (float < $1 billion) still face average costs of $1 million.[43] For smaller companies, SOX costs are meaningful percentages of revenue and cash flows.[44]

B. Indirect Costs

With the enactment of SOX, director workloads increased, along with director compensation.[45] Audit committees on average meet twice as frequently than pre-SOX.[46] Again, related costs fall disproportionately on smaller companies.

The regulations skew incentives. For example, companies may increase dividends or buybacks to avoid becoming accelerated filers subject to 404(b) or may issue more debt than equity to avoid crossing the threshold making them subject to 404(b).[47]

There is even evidence that 404(b) compliance impairs innovation, as proxied by the number of patents and patent citations between regulated and unregulated firms[48] and reduced R&D spending by companies before and becoming subject to 404(b)—without any compensating improvement in financial reporting quality.[49]

A recent review in *Accounting Insights* underscores how SOX has reshaped the operating environment for smaller public companies and private firms considering an IPO:[50]

- *Resource diversion.* Smaller issuers lack the scale to absorb compliance overhead; sizeable portions of operating budgets fund internal-control software, continuous employee training, and outside advisers rather than R&D or market expansion.

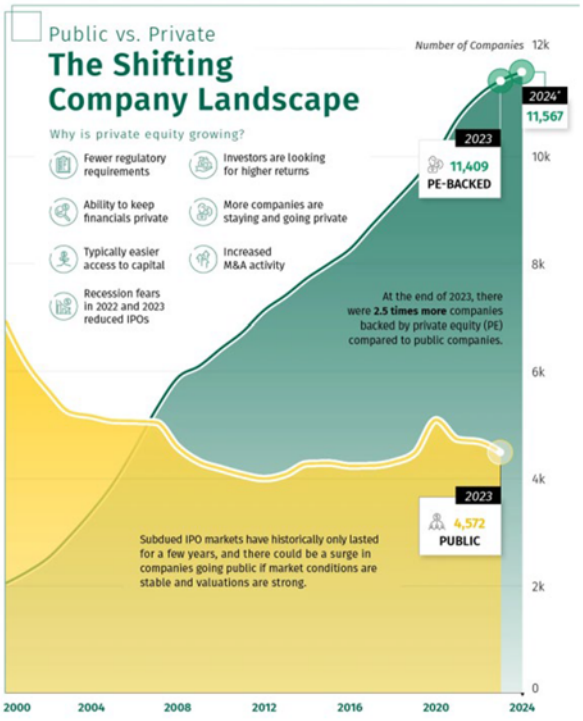
- *Rigid risk-management systems*. To satisfy audit expectations, many firms have adopted large-enterprise internal-control frameworks ill-suited to their size, sacrificing agility for formality.
- *Accelerated reporting cycles*. Shorter filing deadlines and real-time disclosure expectations force small companies to reorganize workflows and invest in advanced reporting tools, again tilting resources toward compliance infrastructure.

V. CAPITAL FORMATION

A core objective of the federal securities laws is to promote capital formation.[51] Yet the Sarbanes-Oxley Act—particularly in its more burdensome provisions—has increasingly worked at cross purposes with that aim, as its rising costs have contributed to the shrinking and shallowing of U.S. public capital markets.

A. Public/Private Markets

Since SOX, the number of public companies has dropped from ~6,500 to ~4,000 while the number of large private companies soared from ~2,000 then to ~12,000 today. (Figure 4 below.)



Source: Citizens Bank (Dec. 2024)[52]

Many factors contribute to these developments, including:

- the rise of private credit markets;
- mergers and acquisitions (M&A); and
- regulatory costs.

While it is difficult for Congress to drive trends in such areas as private credit or M&A, it has substantial control over the regulatory burden. The calculus for going or staying public varies by industry. The IPO-to-exit ratio illustrates this:[53]

- high in pharmaceuticals and biotech;
- balanced in retail, materials, and consumer durables; and
- inverted in banking, software, tech hardware, media, and telecom.

It's also useful to appreciate that companies that deregister their equity securities from public company status may nevertheless issue debt that leaves them subject to certain SOX regulations.[54]

That said, research on SOX's impact reveals factors that likely shape how companies assess the pros and cons of being public versus private:

- negative stock returns of -13% to -15% during SOX's passage[55]
- a rise in going-private transactions post-SOX;[56] and
- the combined cost to smaller firms of audit fees and reduced market value was as high as 167%.[57]

A new study finds that the median public company spends 4.3% of its market cap on compliance.[58] While regulation is not the sole reason for fewer public firms, it is a significant—and controllable—factor.

B. Exits

Over the past two decades, a steady stream of U.S. public companies chose to go private in part to escape the rising burdens of regulatory compliance—especially those imposed by SOX. While the exodus of small-cap companies in the mid-2000s was well documented—more than 200 firms voluntarily delisted or "went dark" between 2003 and 2008, citing the disproportionate costs of Section 404(b)—similar pressures are surfacing again today.[59]

The SEC's own 2011 study on 404(b) recorded how smaller issuers reacted, with one commentator quoted as saying: "When asked if the costs of Section 404 motivated their company to consider going private, 31.5 percent of smaller firms said they were seriously considering it and 38.2 percent said they were somewhat considering it."[60]

In 2017, Staples was taken private by Sycamore Partners in a $6.9 billion deal, after years of regulatory costs and shareholder pressures had worn on its operating flexibility. In 2022, Twitter (now X Corp.) was acquired by Elon Musk in a $44 billion take-private, a move he explicitly linked to concerns about disclosure mandates.

In 2025, both Walgreens Boots Alliance and Nordstrom agreed to go private—deals valued at nearly $10 billion and $6.25 billion, respectively—amid board-level conversations about the rising complexity of operating as a public company.

These are not failing companies fleeing accountability but longstanding businesses opting out of public markets to regain strategic control and shed what they view as excessive procedural burdens. When well-capitalized, brand-name firms exit the public sphere to escape red tape, it signals not just a market shift but a necessary policy inflection point.

C. Entrants

The number of small IPOs has also declined.[61] While private investors increasingly hold firms longer pre-IPO,[62] SOX-related costs—both before and after listing—are material deterrents.

The 2012 JOBS Act offered relief to emerging growth companies (EGCs). Key provisions included reduced disclosure requirements, delayed implementation of new accounting standards, and exemptions from 404(b)'s control audits. Studies show it worked, as scores of companies went public in its wake.

Yet the exemption is temporary, lasting only five years from the IPO. Companies often begin preparing for post-EGC compliance years in advance, incurring costs early.[63] As a result, the exemption is more nominal than substantive for many firms.

The SOX compliance architecture continues to deter some high-growth, innovative companies from going public. The result is a public market that is older, smaller, and less dynamic than it could be.

Big Four accounting firms routinely warn of these costs. Deloitte calls SOX compliance "one of the more significant undertakings" for IPO candidates.[64] EY emphasizes multi-year planning and resource-intensive preparation.[65] These burdens discourage many from pursuing public listing altogether.

VI. Investor Protection

SOX was enacted with a clear intended beneficiary: investors. The law's fundamental purpose was to restore trust in financial reporting and corporate governance after a period of catastrophic failures. Yet even among investors, perspectives on SOX—particularly 404(b)—are not uniform and the empirical evidence mixed.

Evidence about SOX's effectiveness from stock market pricing and reactions is inconclusive.[66] There is some evidence that disclosing material weaknesses may increase a company's cost of capital, particularly for companies who do so continuously for several years. But in general, there is little or scant evidence that adverse 404 disclosures reduce stock price or increase the cost of capital.

The divergence in investor attitudes was evident in comment letters submitted to the SEC on its proposal to exempt certain low-revenue or smaller companies from 404(b). The SEC release depicted this divide (footnotes omitted):[67]

> Many commenters asserted that, even if the ICFR auditor attestation requirement did not apply, other existing requirements would provide investors in these issuers with sufficient protection, . . . including SOX Section 404(a); Nasdaq's listing standards, surveillance, and enforcement; the required management certifications; and the obligation of an independent auditor to consider ICFR when conducting a financial statement audit. . . . Some commenters expressed a view that the ICFR auditor attestation requirement is not important or material to investors generally. . . . One [said] investors do not significantly change

their long-term value assessment of an issuer based on these disclosures. . . .

> Conversely, other commenters asserted that the ICFR auditor attestation requirement is an important investor protection and that eliminating it would undermine such protection. One commenter disputed the contention . . . that eliminating the ICFR auditor attestation requirement for low-revenue issuers would not significantly affect the ability of investors to make informed investment decisions. Some commenters stated that the ICFR auditor attestation requirement increases investor confidence generally and that investors view the requirement as beneficial.

The divergence in investor attitudes may reflect differences in investment strategy, analytical capability, and risk tolerance. Long-term, concentrated shareholders—such as value investors in the tradition of Warren Buffett—tend to analyze financial statements directly, assess accounting quality independently, and scrutinize management's disclosures closely.[68] For these investors, the marginal utility of mandated attestations or internal control audits may be low. They often view such requirements as duplicative of their own due diligence or, worse, as distractions that burden management and distort priorities.

In contrast, passive index investors—who now comprise a significant and growing share of the market—lack the resources, focus or incentives to evaluate the financial reporting quality of given companies. For them, regulatory guardrails such as internal control attestations, CEO/CFO certifications, and PCAOB oversight serve as system-wide protection that enable them to avoid the costs of firm-specific investment research. These investors are less likely to challenge the value of SOX requirements because they rely more heavily on the integrity of the system itself.

What emerges is not a consensus, but a tension: between investors who want greater discretion and those who need stronger assurances; between those willing to pay for customized analysis and those who rely on standardized compliance. That tension reinforces the importance of regulatory flexibility—and cautions against treating all companies or investors as if they face the same risks or possess the same tools.

VII. Pending Legislation

The sub-committee's hearing notice includes two draft bills that reflect a welcome shift toward a more risk-based and proportionate approach to oversight under SOX. Both proposals align with the core themes of this testimony: focusing on material risks, reducing unnecessary compliance burdens, and restoring regulatory flexibility, all without compromising investor protection.

A. Thresholds

One draft bill would require the SEC to revise the thresholds used to determine smaller reporting companies, accelerated filers, and large accelerated filers. The practical effect would be to exempt a broader set of low-revenue public companies from the costly auditor attestation requirement under Section 404(b).

This reform is especially relevant for early-stage life sciences companies, which often must access public markets earlier than other sectors due to their long research and development timelines and limited access to private capital. Unlike technology firms, which may delay public offerings while raising significant private funds, many biotech firms face no viable alternative to

going public. Yet, once public, they are subject to 404(b) audits that can consume $1 million or more annually—resources diverted from scientific work, not from risk-prone financial operations.

This proposal would tailor compliance more appropriately to risk. These firms are typically pre-revenue, have straightforward capital structures, and already face strong market and regulatory scrutiny. They remain subject to management certifications under Section 404(a), financial statement audits, and audit committee oversight. The additional layer of auditor attestation under 404(b) offers limited incremental benefit in this context. Recalibrating the thresholds, especially based on revenue, would relieve a costly burden that does not materially enhance investor protection.

B. Pre-IPO Engagements

A second draft bill would address a growing problem in the application of PCAOB and SEC independence rules. It would require regulators to treat an auditor as independent for work performed before a company became public, so long as the auditor complied with applicable professional standards at the time.

This is a sensible correction to what has become an overly rigid rule. Many private companies engage audit firms years in advance of a public offering. Under current law, if those auditors are later found to have violated technical independence rules—even unintentionally and minimally—the issuer may be forced to switch auditors or re-audit past financials, at significant expense and with no evidence of compromised integrity. This bill would clarify that historical independence should be assessed under the standards in place at the time of the audit, not retroactively reinterpreted after an IPO.

This proposal reflects a broader concern addressed in my testimony: the elevation of form over substance. Rigid compliance rules that add cost without improving audit quality or investor protection undermine the purpose of SOX. Allowing companies and auditors to rely on well-established professional standards—rather than retroactive technicalities—would reduce waste while preserving trust.

VIII. CONCLUSION

SOX has provided companies with an intricate compliance playbook—but not necessarily with more reliable financial reports. By elevating internal control attestations to parity with the audit of the financial statements, SOX has unintentionally shifted attention from *what* companies report to *how* they document the reporting process. The result is a costly culture of control compliance that can obscure, rather than illuminate, real economic performance.

Regulation that evolves with evidence—not ideology—best serves investors, companies, and the economy. This hearing gives Congress the chance to restore balance: to ensure that *accurate financial reporting*, not voluminous documentation, remains the North Star of U.S. capital market regulation.

Some have characterized any effort to reform SOX as tantamount to dismantling investor protections or inviting another wave of corporate scandals.[69] That is inaccurate. The goal of this hearing, and of my testimony, is not to weaken accountability but to strengthen it by ensuring that our laws are properly tailored to serve their purpose.

Twenty-three years after SOX's enactment, we must distinguish between the law's enduring principles and its outdated mechanics. Preserving investor trust requires more than ritual

compliance; it demands a system that prioritizes substance over form, clarity over complexity, and effectiveness over redundancy. Reforming SOX is not about forgetting Enron—it's about learning from such frauds, and from the decades of experience since, to build a smarter, more resilient framework for the future.

END NOTES

[1] My full curriculum vitae is available from https://weinberg.udel.edu/.

[2] See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Might Just Work), 35 Connecticut Law Review 915 (2003); Lawrence A. Cunningham, The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills, 29 Journal of Corporation Law 267 (2004). Excerpts from two of those early articles—written in 2003 and 2004—are included in Appendices A and B because they offer contemporaneous perspective on SOX's enactment, its original policy aims, and the emergence of internal controls as a centerpiece of federal corporate governance.

[3] Comment Letter No. 15, Lawrence A. Cunningham, Docket 008, SEC Release No. 34-49884 (June 17, 2004) [link: rb.gy/yznif5]. The ISB's four-year duration (1997-2001) was cut short by disagreement between the SEC and the profession over the provision of non-audit services to public audit clients, a practice that SOX effectively abolished in 2002. See SEC Historical Society, https://rb.gy/7m8h3t.

[4] SOX had far-reaching effects, including in legal education. In its wake, law school courses on accounting for lawyers began incorporating coverage of auditing. One reflection of this shift was the expansion and retitling of a leading textbook on the subject, which I wrote: originally published as *Introductory Accounting and Finance for Lawyers* (3rd ed. 2002; prior editions dating to 1995), it was renamed I*ntroductory Accounting, Finance, and Auditing for Lawyers* beginning with the 4th edition in 2004 through its current 8th edition in 2023. The length grew accordingly between those editions, from approximately 300 to 500 pages.

[5] John C. Coates IV, The Goals and Promise of the Sarbanes–Oxley Act, 21 Journal of Economic Perspectives 91, 109-110 (2007) (citing Cunningham, The Sarbanes-Oxley Yawn, above).

[6] Cunningham, Appeal and Limits of Internal Controls, above.

[7] See Michael Powers, The Audit Society: Rituals of Verification (1997); Afterword: Audit Society 2.0?, 21 Qualitative Research in Accounting & Management 2 (2024).

[8] See David J. O'Regan, The Closing of the Auditor's Mind? How to Reverse the Erosion of Trust, Virtue and Wisdom in Modern Auditing (2025). O'Regan focuses on internal auditing but his observations apply equally to external auditing—and especially of internal controls.

[9] Paul S. Atkins, Commissioner, U.S. Securities & Exchange Commission, Remarks at the 4th Annual Financial Services Conference (Jan. 31, 2006), [https://perma.cc/3SBT-BMHP].

[10] See Cris Shore and Susan Wright, How the Big 4 Got Big: Audit Culture and the Metamorphosis of International Accountancy Firms, 38 Critique of Anthropology 303 (2018).

[11] The PCAOB implemented the audit requirements for internal control over financial reporting in 2004 through Auditing Standard No. 2 (AS2). AS2 was widely criticized for being overly prescriptive, complex, and costly, particularly for smaller public companies. In response to these concerns, the PCAOB replaced AS2 with Auditing Standard No. 5 (AS5) in 2007. AS5 sought to make internal control audits more risk-based, scalable, and efficient. Public Company Accounting Oversight Board, Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, Release No. 2007-005 (June 12, 2007).

[12] See Advisory Comm. on Smaller Public Companies, Exchange Act Release No. 53,385, at 20 (Feb. 28, 2006) [https://perma.cc/UL7R-3V4J].

[13] For example:

• In 2007, the SEC approved a revised PCAOB auditing standard to simplify compliance, eliminate unnecessary processes, and focus on the most critical aspects of the issuer's internal controls. See Order Approving Proposed Auditing Standard No. 5, Exchange Act Release No. 56,152 (July 27, 2007), [https://perma.cc/3BFT-FN9X]; see also Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 35324 (June 27, 2007) (codified at 17 C.F.R. pt. 241); Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 73 Fed. Reg. 38094, 38094–95 (July 2, 2008) (codified at 17 C.F.R. pts. 210, 228, 229 & 249).

• The 2010 Dodd-Frank Act exempted *non-accelerated filers* from 404(b). See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989G, 124 Stat. 1376, 1948 (2010) (codified as amended at 15 U.S.C. § 7262 (2018)).

• The 2012 JOBS Act exempted *emerging growth companies* (those with revenues less than $1 billion) from 404(b). See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 101, 103, 126 Stat. 306, 307–10 (2012) (codified as amended at 15 U.S.C. §§ 77b(a)(19), 78c(a)(80), 7262(b) (2018) and indexed to inflation). For newly public EGCs, the status ends upon the fifth anniversary of its IPO.

• In 2020, the SEC exempted from the class of accelerated filers "*smaller reporting companies*"—those with revenues less than $100 million. (Estimated savings per company: $210,000, about half in audit fees and half in non-audit costs). See Accelerated Filer and Large Accelerated Filer Definitions, 85 Fed. Reg. 17178, 17178 (Mar. 26, 2020) (codified at 17 C.F.R. pts. 229, 230, 240 & 249). See also 17 C.F.R. § 230.405 (2022) for definitions of "smaller reporting companies."

[14] Stephen M. Bainbridge, Symposium: Sarbanes-Oxley at 20, 78 Business Lawyer 647 (2023) (in 2020 there were 3,142 §404(b) filings compared with 6,205 §404(a) and in 2014 the figures were 3,795 and 7,449).

[15] U.S. Government Accountability Office, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, GAO-06-361 (April 13, 2006), https://www.gao.gov/products/gao-06-361.

[16] Center for Audit Quality, Financial Restatement Trends in the United States: 2013 – 2022 (June 2024) https://thecaq.wpenginepowered.com/wp-content/uploads/2024/06/caq-financial-restatement-trends-us-2013-2022_2024-06.pdf

[17] Audit Analytics, Financial Restatements (June 2025), https://rb.gy/fmg04j.

[18] Stephen Foley, Accounting Errors Force US companies to Pull Statements in Record Numbers, Financial Times (Dec. 9, 2024).

[19] Mark Maurer, Macy's Accounting Scandal Raises Questions About Which Errors Matter, Wall St. J. (Dec. 18, 2024) https://www.wsj.com/articles/macys-accounting-scandal-raises-questions-about-which-errors-matter-fdebaa17?utm_source=chatgpt.com

[20] Karla Johnstone, Chan Li and Kathleen Hertz Rupley, Changes in Corporate Governance Associated with the Revelation of Internal Control Material Weaknesses and Their Subsequent Remediation, 28 Contemporary Accounting Research 331 (2011).

[21] Sarah C. Rice and David P. Weber, How Effective Is Internal Control Reporting Under SOX 404? Determinants of the (Non-)Disclosure of Existing Material Weaknesses, 50 Journal of Accounting Research 811 (2012).

[22] Center for Audit Quality, Financial Restatement Trends, above (page 4, key findings: "Ineffective ICFR reports are generally issued after a restatement is announced, i.e., ICFR reports are not predictive of restatements.").

[23] Id. page 34, figure 16, panel B ("Anywhere between 8% and 26% of the time, the ICFR reports issued in advance of a 4.02 restatement cite at least one accounting issue underlying a subsequent restatement." and "In eight of the ten years under study, a material weakness is reported in reports subsequent to a restatement anywhere between 50% and 60% of the time.").

[24] *E.g.*, Comment Letters on Amendments to the Accelerated and Large Accelerated Filer Definitions (Release No. 34-85814; File No. S7-06-19) of EY (July 29, 2019) https://www.sec.gov/comments/s7-06-19/s70619-5879406-188753.pdf and Deloitte (July 26, 2019) www.sec.gov/comments/s7-06-19/s70619-5877285-188691.pdf.

[25] See Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr. and Ryan Lafond, The Effect of SOX Internal Control Deficiencies and Their Remediation on Accrual Quality, 83 Accounting Review 217, 247 (2008).

[26] Jean Bédard et al., Literature Review: Current Knowledge on Internal Control 9 (2017) *[https://perma.cc/5YWX-AH4N]*.

[27] Id. (citing Gene Kim, Vernon J. Richardson & Marcia Weidenmier Watson, IT Does Matter: The Folly of Ignoring IT Material Weaknesses, 32 Accounting Horizons 37 (2018).

[28] Lawrence D. Brown, Andrew C. Call, Michael B. Clement & Nathan Y. Sharp, The Activities of Buy-Side Analysts and the Determinants of Their Stock Recommendations, 62 Journal of Accounting & Economics 139 (2016).

[29] Ujkan Q. Bajra, Florin Aliu, Armand Krasniqi, Ejup Fejza, The Impact of the Sarbanes–Oxley Act on the Integrity of Financial Reporting: Was it Meritorious?, 34 Journal of Corporate Accounting & Finance 184 (2023) ("financial statement assertions improve with compliance with SOX302 but not with SOX404"); Parveen P. Gupta, Heibatollah Sami and Haiyan Zhou, Do Companies with Effective Internal Controls over Financial Reporting Benefit from Sarbanes-Oxley Sections 302 and 404?, 33 Journal of Accounting Auditing & Finance 200, 200 (2018).

[30] Audit Analytics, SOX 404 Disclosures: A Seventeen-Year Review 4 (2021), https://blog.auditanalytics.com/sox-404-disclosures-a-seventeen-year-review/.

[31] Douglas F. Prawitt, Jason L. Smith & David A. Wood, Internal Audit Quality and Earnings Management, 84 Accounting Review 1255 (2009).

[32] Peter Iliev, The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices, 65 Journal of Finance 1163 (2010).

[33] See Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr. and Ryan Lafond, The Effect of SOX Internal Control Deficiencies and Their Remediation on Accrual Quality, 83 Accounting Review 217 (2008).

[34] See, e.g., Zvi Singer and Haifeng You, The Effect of Section 404 of the Sarbanes-Oxley Act on Earnings Quality, 26 Journal of Accounting, Auditing & Finance 556 (2011).

[35] See Cori O. Crews and George R. Wilson, Sarbanes-Oxley and Earnings Quality, 29 Journal of Finance & Accounting 1 (2021) (reviewing studies).

[36] Id.

[37] CRA International, Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update *5-6* (2005).

[38] Cyrus Afshar & Paul Rose, Capital Markets Competitiveness: A Survey of Recent Reports, 2 Entrepreneurial Business Law Journal 439 (2007).

[39] Proviti (June 2024 polling data) https://www.protiviti.com/us-en/whitepaper/empowering-sox-innovation ("The scope, hours and costs for SOX compliance continue to increase"); see also full report: https://www.protiviti.com/sites/default/files/2024-08/empowering-sox-innovation-protiviti.pdf; KPMG (2023 survey data: 40% of participants reported an increase in the year-over- year cost of SOX, with an average spend of $1.6M, and 11,800 hours). https://kpmg.com/us/en/articles/2023/kpmg-sox-report.html

[40] Protiviti, Benchmarking SOX Costs, Hours and Controls 4 (2018) [https://perma.cc/ZF9B-EHPY].

[41] Protiviti, Benchmarking SOX Costs, Hours and Controls 4 (2019) [https://perma.cc/A4UP-W237].

[42] Protiviti, SOX Compliance Amid Rising Costs, Labor Shortages and Other Post-Pandemic Challenges *2 (*2022) [https://perma.cc/UR46-GWC5].

[43] Protiviti, SOX Compliance and the Promise of Technology and Automation 8 (2021) [https://perma.cc/K4KW-FSJS].

[44] Anwer S. Ahmed, Mary Lea McAnally, Stephanie Rasmussen and Connie D. Weaver, How Costly Is the Sarbanes Oxley Act? Evidence on the Effects of the Act on Corporate Profitability, 16 Journal of Corporate Finance 352 (2010).

[45] *See* Katherine M. Brown, Note, New Demands, Better Boards: Rethinking Director Compensation in an Era of Heightened Corporate Governance, 82 NYU Law Review 1102 (2007)

[46] James S. Linck, Jeffry M. Netter and Tina Yang, The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors, 22 Review of Financial Studies 3287 (2009).

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[48] Huasheng Gao and Jin Zhang, SOX Section 404 and Corporate Innovation, 54 Journal of Financial and Quantitative Analysis 759 (2019).

[49] Abigail Allen, Melissa F. Lewis-Western and Kristen Valentine, The Innovation and Reporting Consequences of Financial Regulation for Young Life-Cycle Firms, 60 Journal of Accounting Research 45 (2022).

[50] Unintended Effects of Sarbanes-Oxley on Business Practices, Accounting Insights (December 12, 2024) https://accountinginsights.org/unintended-effects-of-sarbanes-oxley-on-business-practices/

[51] See Securities Act of 1933 § 2(b), 15 U.S.C. § 77b(b); Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f); H.R. Rep. No. 104-622, at 16 (1996).

[52] https://www.citizensbank.com/corporate-finance/insights/private-equity-trends.aspx

[53] Shivaram Rajgopal, Have Reporting Burdens Led To More Firms Staying Private?, Forbes (June 8, 2025). The variation can be explained by industry features that create different cost-benefit breakpoints. For example, pharmaceutical and biotech firms need substantial, long-term capital and already operate under heavy disclosure norms (e.g., clinical trial transparency), so the incremental cost of public reporting may be relatively low. Firms in banking, software, tech hardware, media, and telecom have easy access to private capital and need to protect sensitive intangible assets, implying a steeper trade-off, where the burdens of being public more nearly outweigh the benefits. It may not be possible to dial regulations to suit these tradeoffs but it is valuable to appreciate them when interpreting data about the effects of regulation.

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[55] Ivy Xiying Zhang, Economic Consequences of the Sarbanes–Oxley Act of 2002, 44 Journal of Accounting and Economics 74 (2007).

[56]Ellen Engel, Rachel M. Hayes and Xue Wang, 44 The Sarbanes–Oxley Act and Firms' Going-Private Decisions, Journal of Accounting and Economics 116 (2007).

[57] Peter Iliev, The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices, 65 Journal of Finance 1163 (2010); see also Shivaram Rajgopal, Have Reporting Burdens Led To More Firms Staying Private?, Forbes (June 8, 2025) (calling that high and suggesting 80%).

[58] Michael Ewens, Kairong Xiao and Ting Xu, Regulatory Costs of Being Public: Evidence from Bunching Estimation, Journal of Financial Economics (forthcoming), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3740722.

[59] See, e.g., GAO, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, GAO-06-361 (2006); Leuz, Triantis and Wang, Why Do Firms Go Dark? 45 Journal of Accounting and Economics 181 (2008).

[60] U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between $75 and $250 Million (April 2011), 74–75.

[61] Vartika Gupta, Tim Koller and Peter Stumpner, Reports of corporates' demise have been greatly exaggerated (2021), https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/reports-of-corporates-demise-have-been-greatly-exaggerated; Vanguard, What's behind the falling number of public companies? https://static1.squarespace.com/static/56cc7bc60442621c56ef83be/t/5d45a132c2f0c50001083645/1564844339212/Vanguard+Shrinking+US+companies.pdf

[62] Shivaram Rajgopal, Have Reporting Burdens Led To More Firms Staying Private?, Forbes (June 8, 2025).

[63] https://www.ey.com/en_us/insights/consulting/why-sox-preparation-can-be-the-key-to-ipo-success

[64] https://www2.deloitte.com/us/en/pages/advisory/articles/ipo-challenges-and-sox-compliance-for-newly-public-companies.html

[65] https://www.ey.com/en_us/insights/consulting/why-sox-preparation-can-be-the-key-to-ipo-success To paraphrase EY's guidance to pre-IPO companies:

- SOX compliance requires the creation of a comprehensive internal control framework from scratch, including a governance structure that separates oversight from execution.
- Companies must identify control owners within business and IT functions and establish steering committees to guide the implementation process.
- Materiality thresholds must be defined, significant accounts mapped, and risks documented. External auditors must be consulted early to align scope and methodology.
- While Section 302 formally requires CEO and CFO certification annually, in practice companies implement quarterly bottom-up certifications from control owners to ensure real-time responsiveness.
- Entity-level and IT-related controls must be documented, with control gaps remediated and a Risk and Control Matrix finalized.
- Internal training is essential to maintain compliance, and companies often spend significantly to ensure that those executing controls are properly trained.
- All of this must be paired with a robust change-management system to assess how organizational or technological changes affect internal controls.

[66] Jean Bédard et al., Literature Review: Current Knowledge on Internal Control 9 (2017) [https://perma.cc/5YWX-AH4N].

[67] Securities and Exchange Commission, Final Rule: Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, Release No. 34-88365 (March 12, 2020), pages 15-20, available at https://www.sec.gov/rules/final/2020/34-88365.pdf.

[68] See Warren E. Buffett & Lawrence A. Cunningham, The Essays of Warren Buffett (8th ed. 2023) (Part VII: Accounting).

[69] E.g., Allison Herren Lee, Commissioner, SEC, Statement on the Rollback of Auditor Attestation Requirements (Mar. 12, 2020), https://www.sec.gov/news/public-statement/lee-accelerated-filer-2020-03-12; Robert J. Jackson Jr., Commissioner, SEC, 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; Comment Letter on Amendments to the Accelerated and Large Accelerated Filer Definitions (Release No. 34-85814; File No. S7-06-19) of Center for American Progress (May 26, 2020), www.sec.gov/comments/s7-11-19/s71119-7228541-217032.pdf;

APPENDIX A

Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work), 35 Connecticut Law Review 915 (2003) (excerpts from the Introduction and Part II.A; footnotes omitted; pagination bolded in text)

The Sarbanes-Oxley Act must be understood in its economic, political and historical context. The Act followed the telecom/dot.com-infused stock market bubble of the late 1990s, which featured new and poorly understood companies. The history of that era will be written many times from numerous perspectives with a scope beyond that necessary to establish sufficient background to understand the climate in which the Act was adopted. A few insights about the environment are offered in a capsule overview, beginning with broader financial trends, highlighting the four galvanizing corporate debacles, and concluding with a sense of the regulatory landscape leading up to the Act.

A. Events

The late 1990s were a period of economic expansion and technological innovation of a magnitude that comes once a generation in American business history. Extraordinary change was led by the exploitation of technologies, enabling the widespread use of the Internet and proliferation of telecom infrastructure. To give one practical illustration of this change, in 1996 hardly anyone used email and a minority used cell phones; by 2000, a vast majority used both regularly.

Heady financial times such as these invariably attract to investing millions of people who lack business knowledge, and to business thousands of people who lack moral scruples. This combination produces and sustains an exaggeration of the real achievements and an obfuscation of the setbacks. With flushness fueling financial fantasies, accounting and corporate governance become, at worst, obstacles to overcome. At best, they become technical burdens to meet as painlessly as possible rather than tools to promote quality financial reporting or disciplined management oversight. The spirit of the times overcomes the spirit of the rules.

The hallucinations of the late 1990s came to an end in March 2000, when investors recognized that a financial bubble had arisen. This drove stock market indexes down—they plunged immediately and remained stagnant for months. Eighteen months later, the terrorist attacks of September 11, 2001 jolted markets and caused complex economic and political **924** uncertainties. Threats to invade Iraq and topple its leadership kept nerves unsteady, an unease that would continue for more than a year.

The unraveling of Enron, a direct product of the era's financial fantasia, began in late 2001 and escalated in early 2002, heightening already high marketplace anxieties. Even then, however, investors held on and markets held sideways, and politicians commenced hearings but kept them on the sidelines. In the early days of the forthcoming domino effect, President George W. Bush was able, with some credibility, to attribute the Enron debacle to a few rotten apples. Other Republicans likewise showed no inclination toward a regulatory response.

As the Enron shenanigans unfolded, the number of obvious rotten apples at the company increased. Also, the number of professional service firms that participated with or aided those rotten apples soared. The brightest spotlight shone on Enron's outside auditing firm, Arthur Andersen, LLP. As the heat bore down on Arthur Anderson, its employees engaged in felonious acts of obstructing justice, such as destroying evidence of wrongdoing and altering records. Such activity resulted in client flight, a criminal jury verdict, and ultimate dissolution. The debacles of Enron and Arthur Andersen provoked

public disgust, Congressional hearings and more than forty reform bills directed at auditor oversight. These bills, however, were put on the back burner.

An accounting meltdown at Global Crossing, Ltd. began to tip the dominos. Dubious financial reporting concerning a wide range of practices and policies surfaced at the telecom industry's darling, just as the Enron disclosures were widening. This was the beginning of the end for Global Crossing and its industry cohorts, and the company sailed toward bankruptcy. Even so, while Democrats in Congress eagerly stepped up hearings, hauled executives and professionals before them, and drafted reform proposals, it remained possible that the upheavals would fade into the recesses of public memory without call for formal political action.

But there was more. A wave of reported corporate debacles mounted the pressure for Congress to respond in Spring 2002. These newer scandals were characterized by distinctly different kinds of misbehavior. For example, the widely-publicized cases of Adelphia Communications Corp. and Tyco International Ltd. involved corporate loans to executives on sweetheart terms. These were stories of individual greed, rather than direct **925** accounting corruption of the type practiced at Enron or Global Crossing.

Other stories involving accounting corruption that had been buried in the business section of top newspapers for years now became front-page news everywhere and feature stories on broadcast and cable television shows. These companies included household names such as AOL Time Warner Inc., Rite Aid Corp. and Xerox Corp. The parade of disparate tales of illicit activity was extended and saturated by events concerning ImClone Systems Inc. This biotech company's CEO allegedly told his father and daughter, and perhaps home furnishings maven Martha Stewart, about company prospects that led to claims of insider trading in violation of federal securities law.

Investors may have been able to properly classify these unrelated events for a while. Enron and the other ongoing accounting scandals were about companies dressing up accounts to obscure the truth; the self-dealing loans made to executives at Adelphia and Tyco were relatively ordinary (if despicable) incidents of corporate misconduct that are the price paid for a market-based system of finance and governance; and events at ImClone concerned arcane regulations governing the wrongful disclosure of nonpublic information. But non-experts in accounting, corporate governance and securities law are not good at maintaining these distinctions (especially when they have just lost enormous investment capital) and the press showed little interest in doing so.

The gales of Enron were strong and these other episodes amplified them. The ultimate tipping point arrived in June 2002, with a true and pure accounting deception so large that there was no turning away from Congressional action, even for President Bush and his fellow free-market Republicans. That month WorldCom Inc.'s internal auditors revealed that top dogs had cooked its books to the tune of several billion dollars, a scandal with partners at other marquee names from the telecom boom, particularly Qwest Communications International Inc., whose starring role in the mischief was uncovered the next month.

926 Not coincidentally, several characteristics adorned each of the four massively scandal-ridden companies—Enron, Global Crossing, WorldCom, and Qwest. First, they were all new. WorldCom effected an initial public offering in 1995, Global Crossing and Qwest both went public in 1997, and Enron transformed during the mid-to-late 1990s from a stodgy natural gas company into a broadband and risk management mirage. Second, these four companies (the "Big Four Frauds") stand out as using

the most appalling accounting and exhibiting the most supine corporate governance. These companies were far different in daring, scope, and type from other accounting or corporate governance aggressions of any period. Third, all used the same outside auditor, the once-venerable and now dead Arthur Andersen. While Enron's aggression was the manifest causal link to Arthur Andersen's demise, the interaction of all four companies with that erstwhile member of the Big Five auditing firms undoubtedly infected its culture.

By mid-summer 2002, the wave of reports from each of the Big Four Frauds seemed endless. Worse, these reports were paralleled by investigations **927** into the practices, during the pre-March 2000 boom years, of additional culpable professionals. Besides auditors and executives, questions were raised concerning the role of securities analysts, lawyers, and credit rating agencies. In many of these cases, particularly with securities analysts, damning evidence surfaced of their complicity.

The multi-billion dollar scale of the Big Four Frauds wrought proportional personal losses for millions of ordinary Americans. All this happened in the wake of the imploding financial bubble that stripped several trillion dollars from equity owners, a large percentage from the same ordinary Americans already directly impacted by the collapse of the Big Four Frauds. This combination of forces produced a natural tendency to overreact. The upshot was the wholesale questioning of the quality of financial reporting throughout corporate America. These calls were made worldwide.

Perspective was in order, but rarely broke through. One conception would have classified the disparate scandals more clearly, emphasizing that Enron was essentially a Ponzi scheme, diabolically engineered and disguised by a coterie of pathological fiends (President Bush was right about that). Another would have observed that the other three members, as well as Adelphia, suffered from telecom mania on their way into the balloon, and telecom fever when it deflated. More broadly, everyone could have been reminded that when the balloon held helium, few complained about manifestly aggressive accounting when business performance was measured by revenue, not earnings or cash; by eyeballs hitting Internet sites, not dollars customers paid. But victims do not like to be blamed.

Despite such plausible but unpopular perspectives, cries to do something were loud and could not be ignored. The noise created political capacity in Congress for reform-minded legislators to craft improvements and pressured those more reluctant to regulate. The result was the Sarbanes-Oxley Act, the product of Congressional hearings conducted throughout the period following Enron's first sordid revelations, and **928** gaining momentum rapidly in the weeks before enactment in late July.

APPENDIX B

Lawrence A. Cunningham, The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills , 29 Journal of Corporation Law 267 (2004) (excerpts from the Introduction and Parts I.C. and III; footnotes omitted; pagination bolded in text; shading to emphasize greatest relevance)

Introduction

Corporate internal controls have become a first-order policy option to respond to a wide variety of national problems. In response to early 2001's financial scandals, Congress adopted the Sarbanes-Oxley Act (SOX), to bolster controls over financial reporting and mandated audits of them. . . .

Accompanying the proliferation of corporate internal controls to address various policy objectives has been a rise of audits to test those controls. But audits are also limited in what they can do. Auditors cannot guarantee that the controls they test are in fact effective, though they can offer some assurance about that. More important, as audit proliferates as a way to test control effectiveness, pressure builds to create controls that can be audited. This means that controls are increasingly designed according to whether they can be audited, not according to whether they are likely to be effective. The proliferation of controls and auditing of them creates so many controls that, by sheer volume, it becomes more difficult to determine which controls are likely to be effective.

Numerous systemic forces make controls appealing as a policy option. . . . Resistance to overt federal preemption of state corporate law makes controls attractive as an alternative way to inject federal policy into internal corporate affairs. The rise of the monitoring model of the board of directors in corporate governance makes controls essential tools to enable this indirect supervision of corporate affairs. . . .

Backing these powerful systemic forces making controls appealing [is] the auditing . . . profession[]. In the case of auditors, controls are an appealing way to diversify the profession's services. Auditors can both design and test controls. The profession encourages control proliferation and auditing of controls as part of its business strategy. In their marketing, however, auditors oversell both what controls can accomplish and how auditing of controls can help make controls more effective. . .

[270] These systemic and professional forces put pressure on having controls and having them audited, rather than having controls that are likely to be effective. Controls to prevent become ends in themselves. Legislators and regulators can adopt or encourage controls in the name of doing something in response to crises. Corporations adopt them as a way to defend against liability claims when undesired events occur despite conscientious controls. Auditors test controls to provide comfort. These choices produce controls for controls' sake. The paradoxical upshot of control and audit proliferation is the more controls there are, the less actual control exists. . . .

[272] Auditors monitoring controls can only test certain kinds of controls. There is a difference between control effectiveness and control auditability. A corporation can have controls that are more effective but less auditable and controls that are less effective but more auditable. The less we trust those whose behavior we use controls to influence by increasing audit, the more controls will be produced that can be audited. But the infallibility complex concerning auditing systematically biases us to controls that can be audited rather than controls that are effective. In this cycle, the end point undercuts the goal: we seek control because we do not trust the agent and then add a monitor who can only monitor certain controls, and those controls may be less effective in controlling the agent's behavior than controls that

cannot be audited. . . .

I. C. Pressure

1. *Systemic*. . . . **[282]** The rising significance of internal controls paralleled the rise of the monitoring model of the corporate board of directors. Internal controls moved from an incident of audit practice to a tool to implement indirect board supervision of corporate performance. The tools address problems of asymmetric information in hierarchical organizations (individual employees have incentives to skew information to their benefit at the expense of the organization') and risks of managerial opportunism (managers with short tenures or compensation tied to short-term performance have interests in conflict with those of the corporation as a whole). The monitoring model's impact on internal controls is akin to deregulation's impact: they trade direct for indirect power.

The monitoring model led to the universal use of audit committees for large public corporations. Audit committees were not common until the late 1970s, after the New York Stock Exchange adopted rules in 1978 requiring them (though the SEC encouraged audit committee use as early as 1940). Audit committees are supervisors of controls. Auditors work with audit committees to conduct financial audits. Both are functionally reliant upon internal controls to aid in the processes intended to enable preparation of fair financial statements. While control and audit are thus distinct exercises, both have grown in parallel fashion since the 1970s and they tend to reinforce each other. Many regulatory directives promoting controls simultaneously promote audits of them.

Self-observation capabilities developed along with this monitoring model and audit committee reliance upon controls. As pressure mounted on boards to assume **[283]** responsibility for designing and administering financial and compliance controls, the corporate internal auditing function blossomed. The evolutionary history of the internal audit function parallels the proliferation of controls generally. Internal audit began as an analogue to external auditing. As controls evolved to include non-financial systems elements, the internal audit function grew to encompass their design, administration and testing. . . .

2. *Professional*. A second force behind the rise and appeal of internal controls--and reinforcing each of these systemic forces--are the professionals involved in selling them. Chief among these are auditors. The auditing profession's business interest is to promote such controls, though somewhat indirectly. Its principal interest is to promote the need for testing and offering assurances with respect to controls. For example, the auditing profession for at least four decades made the case that it is necessary for internal financial controls to be formally and publicly audited, an aspiration finally granted for financial audits of SEC registrants in SOX.

The auditing profession diversified its activities substantially beginning in the mid-1980s, conducting far more attestation services apart from traditional financial audits. The apotheosis of this expansion that emerged since the late 1980s is the ethics audit. This audit reports on management's performance in monitoring the risk of unethical behavior throughout a company.

KPMG's trademark version of this exercise was advertised as "ethics process management," a service related to six risks that bear on corporate ethics: sexual harassment, environmental contamination, antitrust infractions, improper foreign **[284]** payments, fraudulent financial reporting, and race discrimination. In other words: the service is addressed to preventing all the hot-button ills of our time. … .

The AICPA's Special Committee on Assurance Services (known as the Elliott Committee) in the mid-1990s argued for expanding the profession's scope of assurance services, leading many public accounting firms to redesignate their auditing departments as assurance departments. The Elliott Committee emphasized that risk assessment services, a strong growth segment, could rise to 10-20% of annual financial audit fees. . . .

Auditors boast of their product's value. The attestation profession encourages expectations concerning what controls can do and how the profession can help. This is [**285**] true even though these professionals know that inflated expectations may come back to haunt them. In fact, auditors stoke this business. When internal controls are recommended or required, for example, they conduct surveys and report results on who has what level of controls and who does not. This stimulates market growth in the public assurance business, boosting revenue. . .

[295] **III. Control Limits: Audit Views**

. . . SOX requires auditors to attest to assertions management now must make concerning the effectiveness of a company's controls over financial reporting. Auditors have greatest experience with such financial controls. These were created in part to enable them to provide assurance concerning financial statement assertions without need for verifying every transaction. Though even in this exercise controls have limited efficacy, auditor experience with them provides ability to assess these limits with some degree of reliability. When auditors extend their traditional audit tools to investigate and attest to assertions relating to policy controls, limits multiply.

[296] A. Audit Risk

All attestation engagements are designed to provide reasonable assurance as to the covered assertions. None provides absolute assurance. In other words, risk cannot be eliminated. The best a practitioner can do is to hold risk to a relatively-low but statistically-acceptable level. Auditors divide risk into various classifications.

1. *Attestations*. At the broadest level, attestation risk is "the probability that an attestor may unknowingly fail to modify a written conclusion about an assertion that is materially misstated."[122] More focused is the definition of audit risk when applied to a financial audit: "the probability that an auditor may unknowingly fail to modify an opinion on financial statements that are materially misstated."[123] . . . .

In the preliminary stage of an engagement, auditors design tests of controls. These are audit procedures to assess the efficacy of internal controls to prevent or detect material misstatements. The tests address control risk (discussed further in the next section). Evidence from these tests defining control risk is in turn used to set an acceptable level of detection risk; this is done by executing substantive tests.

Substantive tests are audit procedures designed to detect material misstatements or to identify assertions likely to contain material misstatements. They address detection risk. Substantive tests are of two types: (1) tests of detail are designed to detect material misstatements in accounts and (2) analytical procedures are evaluations of data drawing on comparisons such as in relevant trends, baselines or forecasts. . . .

B. Control Risk

Auditors see internal controls as a factor in assessing attestation risk. They posit an inverse

relationship between control quality and audit scope: superior controls demand an audit of lesser scope and intensity; weaker controls demand a more intense and expansive audit. For example, a high-quality internal financial control system can reduce the required scope of an audit while low-quality systems indicate a broader audit plan (all other things being equal). But while audit planning requires an understanding of controls as a source of measuring and minimizing attestation risk, control quality cannot be measured by volume. More controls are not necessarily better or more effective.

Consider the audit risk formula . . . . The model separates the risks but they are in fact related to one another. Suppose two companies embracing identical internal control systems but bearing different inherent risks (one sells only ice cream in the U.S. and the other sells a range of consumer products in 100 countries). Control risk in isolation appears to be the same. But given the different inherent risk, the identical control systems indicate greater control risk in the complex company than in the simple company.

Until SOX, reports on internal controls for SEC registrants were required only when tests of controls revealed significant deficiencies (called reportable conditions). This reporting remains the case for non-SEC registrant reviews of internal controls. Thus there remain two different types of reports on internal control: audit (reportable conditions) and attestation (full test of all controls and opinion on management's assertions concerning control effectiveness, discussed in the next section). Either way, the standard auditor's **[299]** opinion letter on these matters emphasizes the "inherent limitations" of the exercise. . .

[301] C. Auditing Control

Auditing of assertions by navigating an internal control environment is complicated but entails only a partial encounter with all controls. This is an additional limit on auditors' ability to confidently attest to assertions with 100% conviction. As if to overcome this limit of internal controls, accompanying their expansion in the past few decades there has been an expansion of auditing to test them fully.

Auditing is increasingly used to generate comfort in a wide variety of activities, such as environmental operations, employee relations, and compliance with regulatory requirements. Under pressure due to periodic series of heavily-covered corporate **[302]** scandals, from the 1970s to today, corporations have been forced to enhance their internal governance systems. These changes in governance have not only led to the creation of a wide variety of internal controls, but also increased the need for independent parties to audit their effectiveness and integrity. The increasing appeal of internal controls as a policy option is thus accompanied by the increasing appeal of auditing as a policy option. A paradox appears: that the appeal of auditing as a policy option is stoked by the decline of internal controls as a failsafe.

1. *Financial Control Audits*. This is the story of SOX. In the 1970s, the SEC persuaded Congress in response to crises to pass the FCPA requiring companies to have internal financial controls. In the early 2000s, in response to crises perceived to originate in internal control failure, the SEC persuaded Congress to pass SOX requiring auditors to audit those internal controls.

In this cycle of control mandates followed by audit mandates, pressure builds on audits to create controls that can be audited. But we just saw that controls do not automatically reduce audit risk and may increase it. For many contexts, direct-testing rather than control-testing is necessary. Accordingly,

attestations concerning overall control systems tell only a partial story. They cannot speak to the effectiveness of underlying substance over which controls offer no reliable assurance.

SOX nevertheless places enormous confidence in controls, requiring officers to certify them and auditors to attest to that certification. This means auditors must fully assess financial controls, not merely test them as part of a general financial audit. SOX requires officer certifications of the design and effectiveness of internal controls. This move is only a partial sealant. These officer certifications require attestation by those officers that they both designed the control systems and tested them, finding them effective. The risk of self-review bias is self-evident.

To seal this crack, SOX requires auditors to issue a report on an entity's internal control over financial reporting in conjunction with the entity's financial statement audit. Standards for this work were promulgated by the Public Company Accounting **[303]** Oversight Board (PCAOB). . . .

The possibility that effective controls may nevertheless yield materially inaccurate financial statements is critical to emphasize. To the extent it is deemphasized--as it is in the PCOAB's Standard--two key points arise. These apply to the SOX-style audit of financial controls as well as audits of all other types of controls.

First, de-emphasis risks inducing users of control-audit opinions into a false sense of complacency that controls assure outcomes, whether preventing fraud, producing fairly-presented financial statements, or other goals. That raises false expectations, an error that will create costs, not benefits, from any control-enhancement regime.

Second, de-emphasis on the possibility that effective controls do not guarantee substantive results indicates an elevation of the concept of control as an end in itself--control for control's sake, without regard to what controls can do. Controls as ends in themselves are logically less effective than controls consciously designed for instrumental purposes.

A non-corporate parallel illustrates. A university internal-control proposal called for academics given research grants to prepare time-sheets. Part of the motivation was to create a control that was auditable. While the scheme would achieve that objective, it would have skewed incentives toward reading and away from writing or teaching. Also it would not accurately measure the effectiveness of the researcher's performance, as it would simply abstract one aspect from the vast complexities of the underlying activity.

No audit is capable of measuring effective performance, however, for audits seek only to verify data or systems. The point renders audits of controls fractionally valuable compared to audits of assertions. An opinion that time-sheets are being completed (control system checks out) or even that they accurately reflect reading hours (output certified) says nothing about the value of the research (which is ultimately what all the controls and audits are supposed to be worried about). Controls attempt to prevent the need to exercise judgment. But judgments cannot be avoided.

2. *Auditor Advertising and the Expectations Gap*. . . . In addition to direct costs are the costs associated with creating false complacency. The comfort-sense of systems, controls, and audits obscures the real underlying risks. Doing these things may help but risks remain. Audit certifications, both financial and otherwise, direct or of controls, always have offered more than they give. The auditing literature refers to this as the expectations gap.

Some auditors wonder about its source. One factor may be the expectations the profession

creates, compared to the known limits of its craft. The gap widens when auditors advertise products incapable of delivering the promise. Auditors could help close it by aligning their advertisements, and especially lobbying, with the reality they face. After all, this is what they will argue when internal control failures go undetected and victims of fraud or terrorism sue them.

The expectations gap typically refers to the difference between what a financial auditor can do and what investors using financial statements expect. Amid control and audit proliferation this expectations gap assumes larger dimensions. There is an expectations gap between what auditors and controls can do concerning a wide range of policy matters and what the public, lawmakers, and legal culture expects them to accomplish.

One reason for this expansion of the expectations gap is that controls have been transformed from bearing a traditional positive-aspirational function of meeting corporate **[306]** objectives in administrative controls toward a more negative-preventive function of policy/compliance controls. . . .

Chairwoman WAGNER. Mr. Watanabe, you are now recognized for 5 minutes for your oral statement.

STATEMENT OF MR. FRANK WATANABE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ARCUTIS BIOTHERAPEUTICS

Mr. WATANABE. Chair Wagner, Ranking Member Sherman, and distinguished members of the subcommittee, thank you for the opportunity to testify today. My name is Frank Watanabe, and I am the President and CEO of Arcutis Biotherapeutics, a public biopharmaceutical company based in California. I am also the Vice Chairman of Bio, which represents over 1,200 growth-stage biotechs that are driving the search for the next generation of breakthrough medicines.

Arcutis is a young biotechnology company that develops innovative treatments for serious skin diseases like psoriasis and eczema. We were founded in 2016 and went public in January 2020. We received our first Food and Drug Administration (FDA) approval in July 2022, have since received FDA approval for two additional treatments, and we continue to invest in our portfolio of innovative drug candidates. Since inception, we have invested about $1.4 billion in developing our products and have grown from 3 employees to 350, with operations in all 50 States and employees in 39, but we have yet to turn a profit, let alone recoup our massive investments in R&D.

I would like to share some of the challenges that Arcutis faces due to Section 404(b) of the Sarbanes-Oxley Act. While I fully support regulation, it needs to be smart regulation that accounts for a company's size and the cost of compliance. I believe it is unreasonable and wasteful to impose the same compliance requirements on a 350-person biotech with revenues below $200 million as those for an 80,000-person company with $60 billion in revenues as the law currently requires.

We first experienced the overwhelming burden of 404(b) in 2021 when, although we had not generated any sales and we had just gone public the prior year; we became subject to 404(b) when our market cap exceeded $700 million. Two years later, we rolled off of 404(b) when our public float dipped below $700 million, but we could not scale back our costly compliance systems knowing that we would likely need to meet the requirements again, which happened in 2024 when our public float, again, exceeded the 404(b) thresholds. To date, we have spent around $11 million on compliance with 404(b), and those are costs that are rising inexorably. For example, last year alone, our auditor fees were increased by 24 percent. Our switch to 404(b) roughly doubled our auditor fees, and as a small firm, we had to bring in outside control and compliance resources that cost us about half a million dollars a year.

The money we spend on unnecessary compliance is money that we do not have to invest in developing life-altering drugs. I understand the reason for enhanced controls required by SOX. I am old enough to remember those abuses. We all remember, I think, the egregious business abuses that led to the passage of this legislation, but the current thresholds for 404(b) are too low, and Congress and the SEC should take steps to adjust those thresholds. We are grateful to Congress and the SEC for their previous efforts to

reduce the burdens of 404(b) on small businesses, but there is still more work to be done.

Congress can take commonsense steps to reduce the burden of 404(b) on small companies, for example, by adjusting the public float and revenue thresholds as you are considering. It might also amend the 2020 exemption so that companies are exempt if they qualify as SRCs or report revenues of less than $250 million. These changes would reflect the fact that many companies are still small businesses despite having high market capitalizations. Another smart reform might be to use soft triggers for the public float threshold, measuring float over an averaging period of, say, 12 months rather than a single point in time, as is now. I also applaud the proposal that implements a 3-year rolling average threshold for revenue instead of a 1-year snapshot.

Congress should also consider revising the definitions of accelerated and large accelerated filers to better account for low-revenue companies with high valuations, and you might consider establishing a new intermediate tier of filers, helping to ensure that low-revenue innovators like Arcutis are not subject to the same burdensome compliance requirements as mature, highly profitable multinational corporations. Revising the timelines for emerging-company growth status, for instance, by extending EGC from 5 to 10 years post-IPO and raising the public float threshold, would better account for the long development timelines typical in the biotech sector and offer immense release to smaller companies.

While it is not the major focus of the hearing today; I also want to applaud you for your recent hearings on institutional proxy advisory firms. We have suffered struggles with them, and I think it is high time that Congress reformed that sector. Congress has a critical opportunity to support American innovation and competitiveness by modernizing 404(b). Small companies, like Arcutis, are critical to U.S. biotech and the U.S. economy, but we cannot thrive if precious capital is consumed by regulatory requirements of little practical benefit.

Thank you again for inviting me today, and I look forward to the committee's questions.

[The prepared statement of Mr. Watanabe follows:]

Written Testimony of

Frank Watanabe

President and CEO, Arcutis Biotherapeutics, Inc.

Before the Subcommittee on Capital Markets

House Committee on Financial Services

"Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets"

June 25, 2025

Introduction

Chair Wagner, Ranking Member Sherman, and distinguished members of the Subcommittee on Capital Markets, thank you for the opportunity to testify today. My name is Frank Watanabe and I am honored to share my perspectives as President and CEO of Arcutis Biotherapeutics, Inc., a public biopharmaceutical company based in California. I am also the Vice Chairman of the Board of Directors of the Biotechnology Innovation Organization (BIO), which represents Arcutis and over 1,200 other growth-stage biotechs that are driving the search for the next generation of cures and breakthrough medicines.

About Arcutis Biotherapeutics, Inc.

Arcutis Biotherapeutics, Inc. is a young biotechnology company dedicated to developing meaningful innovations to solve some of the most persistent challenges facing patients with immune-mediated dermatological diseases. Arcutis was created out of recognition that innovation in the medical dermatology space had atrophied, forcing many patients to rely on outdated and suboptimal treatments. We focus on developing treatments that address the unmet needs of adults and children suffering from serious inflammatory skin diseases such as plaque psoriasis, atopic dermatitis, and seborrheic dermatitis.

Arcutis was founded in 2016, and we raised three rounds of private financing prior to going public in January 2020 on the NASDAQ exchange (ARQT). We received our first FDA approval in July 2022, have since received FDA approval for two additional treatments, and continue to invest in developing our portfolio of innovative drug candidates. Since our founding, we have invested some $1.4 billion in developing our products, having run 34 clinical trials with our drugs, including 9 large, Phase 3 registrational trials.

In the past 9 years, we have grown from 3 employees to 350 staff today, with operations in all 50 states and employees in 39 states. We are proud to have 2 board-certified dermatologists and 7 dermatology clinicians on staff, and our executive team includes leaders who have worked on

more than 50 FDA-approved products. Our headquarters are in Westlake Village, California, we manufacture our products in San Antonio, Texas as well as Mississauga, Canada, and we have an office in Park City, Utah.

I'm pleased to be here today to discuss policy reforms that can help small innovators—like emerging biotech companies—not only survive but thrive as public companies. My testimony will focus on the challenges Arcutis, along with many of our peers in the biotech sector, have faced under the Sarbanes-Oxley Act of 2002, particularly the requirements of Section 404(b). By sharing our company's experience, I hope to contribute to a constructive dialogue between lawmakers and industry, with the goal of ensuring continued support for breakthrough therapies that companies like ours are working to deliver. To be clear, I fully support regulation, but it needs to be smart regulation that has a purpose. And the compliance costs need to take into account a company's size. I believe it is unreasonable and wasteful to impose the same compliance requirements on a 350-person company with less than $200 million in revenue as those for an 80,000-person company with revenues in excess of $60 billion, but that is what the law currently requires.

Unfortunately, I think it is unlikely that the reforms envisioned in the bill attached to this hearing will relieve Arcutis from 404(b) compliance due to our current capitalization and revenues, but it is my hope that our experience may help other, smaller emerging biotechnology companies avoid unnecessary costs forced by Sarbanes-Oxley Section 404(b).

Unique Position of Biotechs and Challenges of Section 404(b) Compliance for Small Innovators

Like the vast majority of biotech companies, Arcutis is not yet profitable. Drug discovery is expensive, as are scientists and clinical trials. Since our inception, Arcutis has invested $1.4 billion in developing our products, and we generated no sales in our first six years of business. In our nine years of operation, we have not generated a single dollar of profit. Every dollar of our investments in developing, manufacturing, and launching our products has been funded by our private and public investors. And this pattern of high investment costs, long lead times, and reliance on investor capital is typical of the biotechnology industry. In fact, it can often take much longer to develop a drug than it did in our case. Accordingly, our industry places a high value on policies that incentivize investment in innovation and prioritize resource efficiency. Access to capital is crucial. Policies that increase the flow of capital to research and development help produce life-changing and life-saving medicine, whereas policies that divert capital to unnecessary and expensive regulatory burdens stunt innovation.

One of the most burdensome policies for today's biotech innovators is Section 404(b) of the Sarbanes-Oxley Act. Section 404(b) requires the establishment of extensive internal controls and procedures for financial reporting, as well as an external auditor's attestation of those internal financial controls. Though the requirement provides little-to-no insight into the health of an emerging biotech company, it is incredibly costly and onerous for small businesses like Arcutis to comply with.

Arcutis first experienced the overwhelming burden of Section 404(b) in 2021. Although we had yet to generate a single dollar of revenue and had only gone public the year prior, we suddenly became subject to Section 404(b) when the market value of our publicly held shares exceeded $700 million on the testing date of June 30th. And we were not an outlier—within the biotech industry, it's common for small companies with minimal staff, straightforward corporate structures, and no profits to rapidly reach such valuations, as investors value the future potential of creating innovative medical breakthroughs. Yet because 404(b) thresholds are based on rigid, one-size-fits-all market capitalization metrics, we were abruptly held to the same compliance standards as large, profitable multinational corporations.

Two years later, we rolled off Section 404(b) as our stock followed the broader biotech market down, and our public float dipped below $700 million. But even though we technically were not subject to Section 404(b) during the 2023 fiscal year, we couldn't scale back our costly compliance systems, knowing that we would likely become subject to the requirements again, which happened in 2024 as our public float exceeded 404(b) thresholds.

To date, we have spent around $11 million on our compliance with Section 404(b) - approximately the cost of running a large Phase 2 clinical trial. And those costs are rising inexorably- for example, last year our auditor fees went up 24%. Not only did our switch from 404(a) to 404(b) roughly double the fees we have to pay our auditors, but as a small firm, we had to bring in outside control and compliance resources that cost us nearly $500,000 per year. These millions of dollars spent on unnecessary compliance was precious capital that could have been spent on developing life-altering drugs.

And the experience of Arcutis is not unique. One study found that in 2019, Section 404(b) compliance cost emerging growth biotechs an average of over $800,000 per year—that's the equivalent of eight additional researchers, or an additional eight to 16 patients in clinical trials.[1] Studies link 404(b) compliance to a direct reduction in innovation that results in fewer patents. Academic studies also find limited benefits, as biotech investors do not significantly value an additional external report on internal controls for smaller companies, and auditor attestation does not predict future material weakness in internal controls.[2] In short, the academic evidence shows that applying Section 404(b) to small biotechs fails to pass a basic cost-benefit analysis. Instead, it needlessly drains critical capital away from potential cures and breakthrough medicines. If I asked every single one of my investors if they would rather pay an outside firm $2 million every year to issue a report on the effectiveness of the company's internal controls OR use that money towards R&D, the answer in favor of R&D would be unanimous.

I understand the reason for the enhanced controls required by the Sarbanes-Oxley act. We all remember the egregious business abuses that led to the passage of this legislation. But the current thresholds for enhanced compliance requirements enshrined in 404(b) are excessive for

[1] Craig Lewis and Joshua White. Science or Compliance: Will Section 404(b) Compliance Impede Innovation by Emerging Growth Companies in the Biotech Industry? (February 2019)
[2] Ibid.

small companies like mine, and Congress and the SEC should take steps to adjust those thresholds so that these onerous requirements do not draw valuable resources away from R&D investments.

Expanding Section 404(b) Exemptions to Protect Small Businesses

The biotech industry is grateful to Congress and the SEC for their previous efforts to reduce Section 404(b) compliance burdens on small businesses. With that being said, there is still more work to be done. It is important for lawmakers to recognize the unique aspects of the biotech industry and consider further expanding exemptions from Section 404(b) compliance for emerging biotech innovators with little or no revenue.

A recent example of prior efforts to ease compliance burdens came in March 2020, when the SEC voted to create a narrow exemption from Section 404(b) for certain smaller reporting companies with a public float of less than $700 million *and* revenue less than $100 million. While this was certainly a step in the right direction, the amendment overlooked emerging businesses with high valuations, a common predicament for up-and-coming biotech companies. More specifically, by using "and" language, rather than "or", the SEC failed to provide relief to small businesses like Arcutis, which had a public float above $700 million, but zero annual revenues when we first became subject to 404(b) in 2021. There are many other small businesses in a similar predicament, where revenue may be low or non-existent, but their valuation is high.

Amending Section 404(b) Exemption for Low-Revenue Companies

Looking ahead, Congress has several opportunities to support small business innovators by reducing the disproportionate burden of Section 404(b). One approach, as contemplated by the bill attached to this hearing, would be to adjust the public float (from $700m to $900m) and revenue thresholds (from $100m to $250m) for SRCs, which is certainly needed. Congress may also want to consider amending the language of the 2020 targeted exemption for low-revenue companies, so that companies that qualify as SRCs *or* report less than $250 million in annual revenue could qualify. These changes would reflect the fact that many companies, particularly in the biotech sector, retain the characteristics of small businesses despite having high market valuations. Updating the exemption in this way would better align Sarbanes-Oxley compliance requirements with the economic realities these companies face.

Implementing "Soft Triggers" for Public Float Thresholds and Revenue Thresholds

Another option would be to implement "soft triggers" rather than "hard triggers" for public float thresholds. Currently, the 404(b) threshold is simply based on whatever our public float number is on the last business day of the most recently completed second fiscal quarter. Under a "soft trigger" for public float, a company might only become subject to Section 404(b) if it consistently exceeds the threshold over a defined averaging period, such as 12 months, rather than based on a single point-in-time measurement as is the case now. This approach would prevent companies that briefly surpass the threshold from being unnecessarily burdened by costly compliance requirements. It would also provide greater stability for small businesses, protecting them from the volatility and uncertainty that arises as stock prices fluctuate around the

threshold. One day of market fluctuation should not trigger an extra $11 million in expenses for our company.

A one-day snapshot of a company's public float may not tell an accurate story, just like one year of annual revenue may not accurately tell a company's story. I applaud the proposal in the bill that is attached to this hearing that implements a 3-year rolling average threshold for revenue, instead of just a glimpse at one year's annual revenue.

Revising Accelerated Filer and Large Accelerated Filer Definitions

An additional approach is to revise the definitions of accelerated and large accelerated filers to better account for low-revenue companies with high valuations, a typical feature of the emerging biotech space. Congress should consider raising the public float thresholds for these categories, as the attached bill proposes. For large accelerated filers, it would make the most sense to raise the public float threshold to $900 million to align with the bill's proposed definition of a smaller reporting company.

Congress might also consider establishing a new tier of filers to more effectively distinguish small, emerging businesses from large, profitable corporations. Such a tiered system would ensure that low-revenue innovators like Arcutis are not subject to the same burdensome compliance requirements as mature, highly profitable multinational companies.

It is also very confusing that today you can be a "smaller reporting company" with the SEC and also be an "accelerated filer". The bill attached to this hearing clarifies that smaller reporting companies cannot be large or accelerated filers, which is helpful.

Updating the Emerging Growth Company (EGC) Designation

Updating the Emerging Growth Company (EGC) designation would also provide tremendous relief to early-stage innovators. Under current law, companies lose EGC status once five years have passed since their IPO or if their public float exceeds $700 million, regardless of profitability. As a result, many biotechs that are still years away from having a product on the market or generating revenue are prematurely stripped of their EGC status, despite still operating like emerging companies. Extending the EGC designation by an additional five years and raising the public float threshold would better account for the long development timelines typical of the biotech sector and offer meaningful relief from Section 404(b)'s costly compliance requirements. I want to thank Representatives Steil (R-WI) and Liccardo (D-CA) for leading the Committee on this effort.

There are a number of legislative possibilities and definition changes that would responsibly broaden the pool of companies exempt from Section 404(b), easing regulatory burdens for small business innovators and allowing them to focus resources on advancing breakthrough medical discoveries.

Institutional Proxy Advisory Services

I recognize that it is not the topic of today's testimony, but I would briefly like to commend the Subcommittee for your recent hearings into the institutional proxy advisory industry. Arcutis, like many other public companies, has struggled with inaccuracies in their recommendations, recommendations against board resolutions based on arbitrary and unrealistic criteria, and other challenges. Measures by Congress to reform this corner of the public equity markets is sorely needed, and the legislation being considered by the Subcommittee would be important steps in that direction.

Conclusion

Congress now has a critical opportunity to support American innovation by modernizing Section 404(b) to reflect today's market realities. Small businesses like Arcutis are critical to the biotechnology innovation ecosystem—delivering cutting-edge research, driving medical breakthroughs that improve and save lives, and supporting the United States' national security. But these companies cannot thrive if precious capital invested in them to support research and development is instead consumed by regulatory requirements that offer little practical benefit. Tailored, commonsense reforms—whether by amending existing exemptions, adopting soft triggers, or revising filer definitions—would ease unnecessary burdens, encourage continued investment, and protect the innovation pipeline that fuels future cures. I urge Congress to act now to ensure that the compliance framework fosters, rather than stifles, the next generation of medical discovery.

Thank you again for inviting me to provide my perspective on these issues. I welcome the Committee's questions.

Frank Watanabe

Chairwoman WAGNER. Thank you. Mr. Coates, you are now recognized for 5 minutes for your oral statement.

STATEMENT OF MR. JOHN COATES, PROFESSOR OF LAW AND ECONOMICS, AND DEPUTY DEAN, HARVARD LAW SCHOOL

Mr. COATES. Chair Wagner, Ranking Member Sherman, Ranking Member Waters, Chair Hill, thank you, members, for the opportunity to speak here. The last time I testified before you was during coronavirus disease (COVID), so I did not get to be in this nice room. Good to be here in person.

I am going to quickly go through a few themes that I think provide some counterpoints to what you have heard so far. First, SOX—I just want to make sure everybody has this right—is a disclosure law. It does not actually require a company to do anything different than its management believes is correct or controls. It can report publicly that it disagrees with its auditor as to some of those judgments, and many companies do. So, Frank, you might want to talk to your lawyers if they are telling you you have to follow the auditor's directions about your controls, even when you think the costs outweigh the benefits. You do not have to.

The disclosure elements of this law make it a less costly law than some of the alternatives. Other countries, in some places, actually directly specify the kinds of controls companies have. We do not in this country. We rely on companies in the first instance and then disclosure so that investors whose money is being risked with the control systems in question can judge for themselves how and when to price their investments in those companies.

The benefits of the law are clear. Professor Allen's study, which I commend as a very good study, and she said this in passing, but I just want to make sure everybody heard it, shows that most companies—most companies—are subject to 404(b) benefit. Their financial quality is better as a result, and even in the period that she was studying, the costs did not outweigh the benefits. Now, something that was not mentioned so far is that PCAOB softened 404(b) in 2007, using its discretion under the law to do so, and I would think the kinds of issues that have been raised where the 404(b) may not be translated properly for a given company could be addressed by the PCAOB or the SEC.

I will note that under a public administration, nothing happened 2 terms ago. The PCAOB could have, at that point, made more modifications. They could have said for an early stage company with 300 employees, we do not need the auditors to do quite the testing that they do for Goldman Sachs. The PCAOB was not, under Republican leadership, willing to take up that challenge. You can ask the members who ran it back then why. It could be done today. The SEC is now under Republican Administration and could take up this challenge directly. The kinds of things that I heard Frank suggesting earlier, they are perfectly appropriate things, I think, for the SEC to consider, but I am not sure that a Federal statute is the right vehicle for doing the kind of fine-tuning that goes to average versus point in time, et cetera, because, in fact, we are probably not going to know in advance what the right calibration is, and it is the kind of thing you would want the agency to be able to fine-tune over time. If you block it into a statute—we all

know in this room how hard it is to pass statutes—it is likely to get outdated fairly quickly. I will note SOX does not do that. SOX delegates to the PCAOB and the SEC authority to make changes in how auditors go about their work, and so that could be done under current authority.

A few other things. Many companies choose, even though not required, to comply with 404(b) today. There are many private companies who have voluntarily done this. There are many companies that float bonds when they could float leveraged loans and be able to get out of 404(b), but they choose not to. That suggests that the debate over this issue is not nearly as clear-cut as it sometimes is presented. Other countries have followed the United States. Most countries now have the equivalent of SOX, so it is not the case that the United States is some outlier in this respect.

Last thing I would say about the proposals is that you really need to think hard about the risk that a statutory change will open the door again to the kinds of bad reporting that went on leading up to the passage of SOX. Chair Hill's family's bank, when it was bought by a public company, was bought by a public company bank subject to SOX. They paid about $5 million for a total audit, including 404(b), in the year of that deal. I believe the stock that was paid as part of the consideration of that deal was more accurately priced and reliable as a result of Sarbanes-Oxley and that the deal might have been a little bit more fraught if there had been the kind of accounting that went on in the 1990s present at the time of that deal.

Thank you. I will stop here.

[The prepared statement of Mr. Coates follows:]

Testimony of John C. Coates IV[1]

Before the Subcommittee on Capital Markets of the

Committee on Financial Services

United States House of Representatives

on

Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets

June 25, 2025

[1] For identification only: John F. Cogan Professor of Law and Economics, Harvard Law School.

Chairman Wagner, Ranking Member Sherman, and members of the Subcommittee, I thank you for inviting me to testify. Effective law and regulation are crucial foundations for capital markets, and by protecting investors and lowering the cost of capital, they are central to America's success. I am honored to participate in a reassessment of the Sarbanes-Oxley Act, about which I have published peer-reviewed articles in law, accounting, and economics journals.

Background and Experience

Before joining Harvard, I was a partner practicing securities law at Wachtell Lipton Rosen & Katz, working on matters from Arkansas to Idaho, from Maine to Texas. I represented companies going public for the first time, and I was a primary lawyer on more than 50 large M&A deals, for both buyers and sellers, involving public and private companies, multinational banks and family-owned businesses. I worked for Goldman Sachs and other major banks, as well as small, independent brokers and investment advisers. During that practice, I helped companies cope with disclosure and control obligations, as well as mitigate and respond to the risks created by their absence when (for example) representing public companies buying privately held businesses.

In 2021, I had the honor of serving as General Counsel of the Securities and Exchange Commission, and before that, as Acting Director of the Division of Corporation Finance during the largest IPO boom in world history. In those roles, I oversaw enforcement of the Sarbanes-Oxley Act and participated in the SEC's oversight of the PCAOB. From time to time, I have advised the PCAOB, working with other academics from the Graduate School of Business at the University of Chicago, to help the

Board align its practices and standards with the best information and insight that serious research can offer.

At Harvard, I have for nearly thirty years taught, researched and written about disclosure and the costs and benefits of law and regulation of disclosure, in both the law school and the business school, in degree programs and executive education sessions with directors, CEOs, and general counsels. I published one of the first evaluations of the Sarbanes-Oxley Act (in the *Journal of Economic Perspectives* in 2007, cited more than 750 times by other scholars),[2] and in 2014 co-authored with a colleague at the business school a ten-year, multi-disciplinary literature review of research on that law that became one of the top-cited articles at the intersection of accounting and corporate governance in all peer-reviewed journals focused on accounting and auditing.[3] I have authored two studies of economic analysis of financial regulation, including a detailed cost-benefit analysis of one of the most important parts of SOX, item 404, which requires disclosures about financial controls.[4]

Finally, I note that for seven years, I served as an independent monitor for the DOJ and a compliance consultant to the SEC overseeing a systemically important financial institution. In that work, I managed a team of more than 25 lawyers and forensic accountants and other specialists. I was required to and did evaluate the costs and benefits of control and compliance systems, and experienced firsthand the challenges of deterring,

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[2] The Goals and Promise of the Sarbanes-Oxley Act, 21 J. Econ. Persp. 91 (Winter 2007).
[3] John C. Coates and Suraj Srinivasan, SOX After Ten Years: A Multidisciplinary Review, 28:3 Accounting Horizons 627 (2014).
[4] Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015); Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale Law Journal 882 (2014-2015).

mitigating and responding to control weaknesses through policies, procedures, testing, internal auditing, and engagement with external auditors and regulators.

In the rest of this written testimony, I offer (a) a few general observations about the Sarbanes-Oxley Act, (b) a summary of some of the effects of the law, and (c) a concluding point about compliance costs.

1. General Observations about the Sarbanes-Oxley Act

In this section, I make a few general points to clarify what SOX did and did not do: (1) SOX is a disclosure law, and disclosure laws provide enormous benefits to the economy; (2) control systems long pre-dated SOX, and were not imposed by SOX; (3) SOX never imposed a "one size fits all" rules on US businesses; (4) the creation of the PCAOB directly followed from the failure of self-regulatory bodies to preserve quality audits for US public companies; (5) the requirement that PCAOB-supervised auditors be retained by broker-dealers was a direct result of the Madoff and Stanford scandals; and (6) the PCAOB plays a particularly important role in protecting US investors in China-based companies.

1.1. SOX is a Disclosure Law and Disclosure Law Add Enormous Value

The core of SOX, as with the rest of the securities laws, is a set of disclosure obligations. Disclosure has many virtues, and as compared to command-and-control regulation, imposes fewer costs. Disclosure enhances legitimacy. Disclosure is necessary for accountability. It allows investors and enforcement officials to hold corporate agents responsible for theft, fraud, or violations of other laws. Disclosure provides a basis for lawmakers to evaluate whether current laws are doing what they are intended to do. These lawmakers include Congress, the SEC, and ultimately, in a

democracy, the public. Disclosure provides a foundation for improving law more generally over time.

As an economic matter, disclosure improves the allocation of capital for sustained growth. Basic theorems of economics that undergird our nation's preference for free trade commonly assume among other things that stock traders are on a basic, level, informational playing field, which allows them to differentiate themselves based on insight, analysis and their own research, and mitigates the risk that a would-be seller is simply trying to engage in fraud. Disclosure laws help move capital markets towards that ideal. While voluntary disclosure is common and valuable, well-designed disclosure laws add value. They create standards, ensure comparability across companies, add enforcement tools, greatly improve the credibility and reliability of the disclosures, and reduce the risk of theft and fraud. With respect to SOX, more than 45 asset managers led by the Council of Institutional Investors have stated that auditor attestation of control disclosures is "an important driver of confidence in the integrity of financial statements."[5]

Disclosure laws are not a panacea. They have costs, although those costs are often overestimated. Generally, those costs fall – often dramatically – over time.[6] But disclosure is a mild and often clearly efficient means to address specific problems. The public tends to demand legal change in response to crises, market crashes or corporate scandals. Those responses can be prescriptive, especially if the behavior involved took place in the dark. Disclosure reduces overreactions.

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[5] https://tinyurl.com/yjmd27u2.

[6] See Coates and Srinivasan, supra note 2; see also John C. Coates, Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015); John C. Coates, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale Law Journal 882 (2014-2015).

The role of sunlight in deterring misconduct is too well known to elaborate. Disclosures can be processed by analysts, who provide summaries and recommendations to others. For example, as I have written about with Dean Glenn Hubbard -- who served as Chairman for President George W. Bush's Council of Economic Advisors -- the Investment Company Act is one of the most successful disclosure laws of all time.[7] It requires disclosure of much information that few investors ever learn about directly. But the disclosures are consumed, analyzed and simplified by financial advisors and intermediaries such as Morningstar. The U.S. has the most successful fund industry in the world, thanks in significant part to mandatory disclosure laws.

Consistent with these observations, many countries imitated the U.S. in adopting SOX-like statutes or regulations following the market downturn in 2001.[8] In 2006, for example, Japan adopted its own so-called ''J-SOX'' statute, with provisions equivalent to sections 302 and 404 of SOX. In 2006, the European Union, too, adopted an Eighth Directive on securities disclosure, which largely tracked much of the contents of SOX.

1.2. SOX Did Not Mandate Control Systems

SOX did not mandate control systems, nor require any particular change in their use or design. Rather, controls are voluntarily self-imposed as a matter of common sense and best practices by most businesses and are required by state corporate law for all companies, and by the FCPA for public companies. Most organizations, for example, limit how much money any single employee is authorized to spend on behalf of the organization, without getting formal approval from senior authorized agents, such as a

[7] John C. Coates and R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151 (2008).
[8] E. H. Kim and Y. Lu, Corporate governance reforms around the world and cross-border acquisitions, 22 J. Corp. Fin. 236–253 (2013).

board; likewise, many organizations require two signatures by two employees for larger expenditures. In our modern computer era, many controls are embedded in technology, controlling who has access to corporate data and who can initiate changes in books and records, and through what process. Without controls, businesses (and their investors) are exposed to greater risks of theft, fraud and both public and private corruption, as characterized the Watergate era and seems on the rise again today.

1.3. SOX Never Imposed a "One Size Fits All" Approach

The U.S. has never imposed "one size fits all" regulation in securities law; that generalization includes SOX. The Sarbanes-Oxley Act does not apply to private companies, for example, even if owned indirectly by millions of Americans through pension funds and other intermediaries. Smaller public companies have never been required to obtain attestations from their auditors about their control disclosures,[9] and emerging growth companies – those going public for the first time – enjoy generous exemptions as well. Standards governing auditor attestation of control disclosures have since 2007 permitted risk-based approaches, allowing for significant variation in the design and operation of controls.

Even large, mature public companies covered fully by section 404 of that Act may have control system weaknesses, as long as they disclose them. Companies are not required to do what audit firms think is necessary for an effective control system. If companies inform investors, they may (and often) do choose to accept the risk of theft and fraud in order to save money on more expensive controls. The value of the law is to set an overall baseline for disclosures by the largest public companies about control

[9] The SEC increased the size of exempt small and mid-size companies from the full requirements of SOX in 2020, over the objections of many investors. https://tinyurl.com/29n7fzk6; see note 5 supra.

systems. As noted above, most private companies adopt controls voluntarily, and many choose to have their auditors perform a SOX-equivalent attestation on the effectiveness of their controls, in order to assure lenders and investors as to the reliability of their financial statements, reducing their cost of capital.[10]

1.4. The PCAOB Responded to the Enron Era of Failed Self-Regulation

The creation of the PCAOB by President Bush and Congress through SOX was bipartisan and nearly unanimous. The reason for that near unanimity was that it followed a decade of deteriorating accounting and auditing outcomes for US public companies. Restatements, earnings management, and fraud all rose in the period during which the audit profession's only overseers were largely toothless self-regulatory bodies, backed sporadically by the underfunded and overtasked SEC. The culmination of this deterioration was a host of accounting failures, including Enron and WorldCom, which resulted in massive bankruptcies and investor losses.[11] What set this era apart was that financial failures were not limited to small or under-resourced companies, but included large companies. The PCAOB was created to fix this broken system, with its main tasks being to register, set standards for, inspect, investigate, and discipline public company

[10] E.g,, Robert P. Bartlett III, Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions, 76 U. Chi. L. Rev. 7 (2009); Alexey Lyubimov, Larry Davis, & Greg Trompeter, The Impact of the Sarbanes–Oxley Section 404(b) Exemption on Earnings Informativeness, 24 Int'l J. Audit. 3 (2020).

[11] Losses of between 10% and 30% are typically experienced by owners of companies revealing financial frauds, and of course shareholders can be wiped out in the event of bankruptcy. See Patricia M. Dechow et al., Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 Contemp. Acct. Res. 1, 27 (1996) (stock price declines upon revelation of fraud average 9% of market capitalization); Karpoff, J. M., Lee, D. S., & Martin, G. S. (2008). The cost to firms of cooking the books. J. of Fin'l and Quant. Anal., 43(3), 581–611 (average decline of 38% upon revelation of fraud). Worse for investors generally, fraud has spillover effects on other companies, dragging down the stock prices (and raising the cost of capital) for innocent but similarly situated companies. Eitan Goldman, Urs Peyer, Irina Stefanescu, Financial Misrepresentation and Its Impact on Rivals, 41 Fin. Mgt. 915-945 (2012).

audit firms. Last year, the PCAOB reported its staff inspected over 230 audit firms and reviewed over 900 audit engagements, including in mainland China and Hong Kong.

1.5. Brokers Were Brought Within the PCAOB by the Madoff and Stanford Scandals

As those affected will never forget, Bernard Madoff and Leland Stanford orchestrated massive Ponzi schemes uncovered in 2008 and 2009, losing investors billions of dollars. One investor lost over $1 billion and committed suicide – consistent with a body of research finding that suicides increase significantly in response to large capital market frauds. A key factor in many older Ponzi schemes (including the Madoff scheme) was the use of brokers audited by under-resourced firms not registered with the PCAOB. In 2010, Congress extended the requirement to have PCAOB-inspected auditors to broker-dealers. While Ponzi schemes never go away, none has endured long enough to reach the Madoff/Stanford scale since the requirement of PCAOB-inspected audits of brokers.

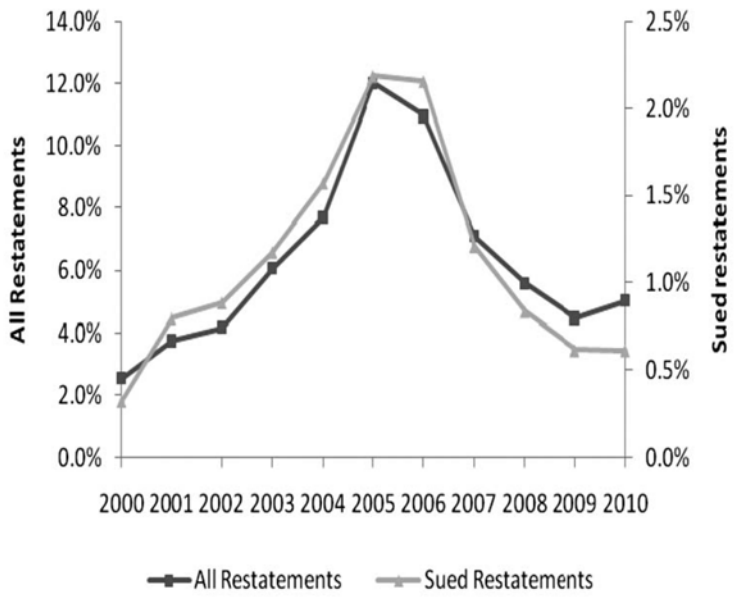
1.6. China-based Auditors Were Permitted to be Inspected

The PCAOB has played a vital role in protecting investors in companies cross-listed into the US from countries – such as the People's Republic of China (PRC) – that historically had weak auditors and posed acute investment risks. Congress unanimously approved the Holding Foreign Companies Accountable Act in 2020, a bipartisan law to improve foreign accounting and auditing, through the mechanism of PCAOB oversight of foreign auditors, backed by the threat of delisting. The HFCAA has worked. In 2022, the PRC accepted PCAOB inspections of PRC auditors as the first and only regulatory body with such access. Unwinding the HFCAA's accomplishments would expose US investors to heightened risks of fraud and abuse.

2. Effects of SOX

In this section, I briefly summarize research on some of the effects of SOX:

- A survey by the Financial Executives Research Foundation in 2005 found that 83% of large company CFOs agreed that SOX had increased investor confidence, and 33% agreed it had reduced fraud.
- A survey by the GAO in 2013 found that 80% of all companies viewed auditor attestation under SOX 404(b) as benefiting the quality of a company's controls, 53% viewed the requirement as benefiting their company's financial reporting, and 52% reported greater confidence in the financial reports of other section 404(b)-compliant companies.
- Restatements of financial statements by companies subject to SOX initially grew, as audits increased in quality, and then fell, as companies began to maintain better financial controls and financial reporting quality improved, as shown in the accompanying figure (from Coates and Srinivasan, supra note 2).



- Quoted bid/ask spreads in the stock markets were widening prior to the passage of SOX, reflecting the effect of scandals on market liquidity and the willingness of dealers to expose themselves to potential adverse selection in trades. After SOX, spreads fell significantly, consistent with a return to greater market confidence and lower costs of capital for all firms.
- Compliance costs initially rose, as companies spent more on audits and internal controls to avoid negative market responses from disclosures of widespread control weaknesses. After the initial ramp-up in expenditures, however, costs began to decline, on an inflation-adjusted basis, particularly after 2007, when the PCAOB's revised audit standard (AS5) permitted companies and audit firms to use a variety of cost-savings measures in implementing and making disclosures

about financial controls. Costs have continued to increase in nominal terms since the post-2007 period, but not in excess of inflation or overall increases in professional service costs generally.

More generally, there is no serious debate that the PCAOB has improved the linchpin of the US financial system, public company auditing. By setting standards for auditing, and by inspecting audit firms, it has augmented auditing practices and improved the reliability of financial reporting. That, in turn, has improved capital market liquidity and lowered the cost of capital.[12] The PCAOB's role has not been a "fix it once" task – accounting practices and the requirements for effective auditing evolve over time, in tandem with changes in business practices, technology, and financial risks and opportunities. Nothing suggests that now is an appropriate moment for the PCAOB's work to be brought to a sudden end.

Finally, it is sometimes claimed that SOX has impeded initial public offerings in the U.S. The data disprove this: 2021 – with SOX long in place – was the historical peak for IPOs.

[12] Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney Jr, Ryan Lafond, The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity, 47 J. Acc'g Res. 1-43 (2009) ("we find that firms with internal control deficiencies have significantly higher idiosyncratic risk, systematic risk, and cost of equity. Our change analyses document that auditor-confirmed changes in internal control effectiveness (including remediation of previously disclosed internal control deficiencies) are followed by significant changes in the cost of equity that range from 50 to 150 basis points.").

Whatever the net costs and benefits are of SOX overall, the law has not impeded primary capital formation in a detectable way. It is worth noting, too, that surveyed chief financial officers of companies considering going public did not identify SOX as a major deterrent.[13]

3. Compliance Costs of SOX

As a final point about compliance costs, it is of course true that disclosure laws – like all laws – generate compliance costs. Companies must dedicate employee time to the disclosures, lawyers must assist in reviewing them to minimize the risk of enforcement or litigation, and external auditors charge higher fees to attest to disclosures about financial controls. Yet, as noted above, compliance costs fell due to the PCAOB's adoption of AS5 in 2007, and after adjusting for inflation, audit fees remained nearly flat from 2012 to 2021, and either were flat or declined in 2022 and 2023. Companies of course paid more, due to inflation – so you will no doubt read or hear that compliance costs are continuing to rise. And audit fees are not the only component of compliance

[13] James C. Brau and Stanley E. Fawcett, Initial Public Offerings: An Analysis of Theory and Practice, 61 J. Fin. 399 (2006).

costs under SOX. But there is no evidence that SOX compliance costs have been rising at any faster rate than the money supply in the overall U.S. economy.

More importantly, it is simply a mistake to assume that – if SOX were repealed, for example – companies would stop making control-related disclosures. Investors (and lenders) would continue to expect them, and continue to expect companies to have control systems, and to be able to credibly say they are in control of their assets and that their financial statements are reliable. No doubt compliance costs would fall somewhat without SOX, but along with that drop would come an increase in capital costs, due to an increase in the risk that investors' money would be stolen or misused. When it comes to the basic foundations of capitalism, there has never been such a thing as a free lunch.

Chairwoman WAGNER. Now I will turn to member questions, and I recognize myself for 5 minutes for questioning.

Mr. Watanabe, experts have argued that the benefits of requiring an external audit testing to internal controls under Section 404(b) are outweighed by the annual costs for early stage or biotech companies which can amount to over $800,000. In your case, you cited much higher. Can you discuss your experience in running Arcutis Biotherapeutics, a small public biotech firm, and whether the funds spent on Section 404(b) compliance had to be reallocated from, let us say, R&D and product development and other things?

Mr. WATANABE. Yes, thank you for the question, Chairwoman. Yes, it has been a significant expense for our company. Our audit fees alone last year were $2.2 million. We still are in the middle of this year. I would estimate we will probably be in the range of $2.5 million plus this year just for our audit fees. In addition to, as I mentioned, I think, before, we are spending about $500,000 a year for support for our compliance program to meet the standards that are imposed on us by our auditors, and that is money that has to come out of R&D. That is the variable cost in a biotech company like ours, and so we are not investing that money in developing the next generation of cures. I would also say that our audit fees about doubled when we went from 404(a) to 404(b) just given the complexity of the audit that the auditors required.

Chairwoman WAGNER. Thank you. Dr. Allen, according to your research, young lifecycle firms experience a significant decline in innovation after becoming subject to SOX. Your findings estimated declines between 9 and 12 percent in R&D intensity and 6 percent decline in patent filings for young lifecycle firms relative to pre-SOX levels. In addition to the decline in the level of innovative activities, your research also found that post-SOX young lifecycle firms pursued less valuable patents. I found that interesting. Can you discuss how SOX implementation forces young lifecycle firms to alter their innovation process?

Dr. ALLEN. Certainly. I would say that the idea here is that in addition to diverting direct resources, spending on research and development, or time spent on research and development, the centralized control formalization of processes, and reduced flexibility that often accompanies the implementation of internal controls can be at odds or mismatched with the decentralized flexible risk-taking environments in which exploratory innovation thrive. So, I will just put a sub-point there, two types of innovation: exploratory innovation, which is strategically oriented toward new markets, new products, has a high probability of failure, and exploitative innovation, which actually takes incremental steps using existing processes and knowledge. While exploitative innovation conducted by more mature firms might actually benefit from more centralized controls processes, the exploratory innovation that young lifecycle-stage firms are engaging in is often mismatched with the control environment imposed by SOX and that is where we think the difference comes from.

Chairwoman WAGNER. Thank you. Mr. Cunningham, despite the costs and disruptions to innovation processes due to SOX compliance, research suggests that young firms do not experience compensating benefits, such as substantial improvements in financial

reporting quality, to offset these challenges. Can you discuss how the incremental improvement in quality achieved through SOX compliance might not be as significant for smaller issuers compared to complex, multinational corporations?

Mr. CUNNINGHAM. Yes. It is very important to appreciate that when an auditor conducts an audit of the financial statements, it is required to test the internal controls and assess the controlled environment. So, that is an activity that is part of the regular financial audit, and for relatively simple firms, low-revenue firms, early stage firms, that is sufficient, and you are not going to get a big bang, a big incremental gain if you then say the auditor also has to give a certification and attestation, a full audit of the entire control environment.

Chairwoman WAGNER. Thank you. Mr. Cunningham, many companies cite SOX as a factor in their decision to go or remain private, including in the recent cases of Nordstrom, Staples, Twitter, now X, and Walgreens. If large, established companies with robust resources find SOX compliance burdensome enough to consider privatization, this begs the question, how are smaller public companies supposed to cope? I am out of time. I will let you respond in writing if that is all right.

Mr. CUNNINGHAM. Yes, fine.

[The information referred to was not submitted prior to printing.]

Chairwoman WAGNER. Next, the chair will recognize the gentleman from Georgia, Mr. Scott, for 5 minutes for questioning.

Mr. SCOTT. Thank you very much. Twenty two years ago, when I first was appointed to this committee, I served with one Barney Frank and worked closely with Barney on this bill. I want to point out at the outset that my Republican friends are unilaterally disarming the United States against China and cutting our regulators' access to audit firms, exposing working families and investors to greater risk. This is so seriously, and I urge my Republicans, do not destroy this wonderful mechanism, this bill that gives the American public protection against China.

Mr. Coates, if foreign-based auditors can operate with no oversight, will this not create an unfair competitive advantage for companies using those firms?

Mr. COATES. Yes, sir, it would, and it would return us to the period before this body passed the bill that led the PCAOB to negotiate the memorandum with the People's Republic of China, during which China companies defrauded U.S. investors with a greater propensity and severity than they are doing today. I will note, too, some have suggested the SEC could take over that role that the PCAOB has provided. Those memoranda are with the PCAOB. The People's Republic of China would get to walk away from them if the attempt was made to transfer inspection authority to the SEC instead.

Mr. SCOTT. Yes, and can you speak a little more about this uneven playing field and the potential for distorting capital allocation and market confidence?

Mr. COATES. You raised a very excellent point that has not come up yet. The principal driver, I think, for SOX was fraud, but the biggest benefit it has provided is to improve the allocation of capital to firms like Mr. Watanabe's. The precision with which you can

price stock depends on the reliability of the financial statements, which includes the reliability of controls. One quick word on controls: controls are kind of basic. Most companies have them, just to be clear. I am quite sure that your company had controls before it even ran into SOX. There may be layers of cost added onto them, but to not have any requirement that anyone check whether the controls are adequately designed for China-based companies will tilt the playing field in a way that means that some of the capital that appropriately should be allocated to U.S. companies will be misallocated, I believe, to China companies.

Mr. SCOTT. Yes. Now, let me make this point, and I think you touched upon it, but it is very important. Private enforcement through securities litigation relies on public disclosures and audit reliability, so if regulators cannot inspect or investigate audits, will investors not have fewer tools to pursue legal remedies for fraud or misleading statements?

Mr. COATES. I believe you are absolutely right about that, too. It was said earlier that restatements have continued, and that is true. Many companies still make mistakes today, but the incidence of fraudulent misstatements have not risen anywhere close to the levels that they were before Sarbanes-Oxley. That is partly because the private litigation and the inspections together are a more powerful deterrent to fraud.

Mr. SCOTT. Now, I want my good Republican friends to understand this major point. If investors believe that Chinese or foreign companies are exempt from scrutiny, this will erode trust in our financial statements of all U.S.-listed companies with foreign operations or auditors. This is significant. Thank you.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from Arkansas, Mr. Hill, the Chair of our full Financial Services Committee, for 5 minutes for questioning.

Mr. HILL. Thanks, Chair Wagner. Let me thank the panel for a great testimony. I appreciate it very much. I want, Mr. Cunningham, to start with you and maybe reflect on Professor Coates' comment that somehow this is all optional, that if a company wants to do it, they can do it, but a company does not have to do it. Could you start out by just giving us your view on that comment? I thought it was a thoughtful comment. I want to make sure we are clear on the record about that.

Mr. CUNNINGHAM. Yes, thank you very much. Professor Coates' assertion is that Sarbanes-Oxley is all about disclosure. It only requires disclosure. It does not require any substantive activity. At a high level of theory, there is some truth to that, but there are some very important practical exceptions. Just to take an example, the audit committee rules are mandatory. You have to have independence. Literacy, oversight, very prescriptive, very substantive, has virtually nothing to do with disclosure. The SOX audit, the external audit of internal controls, is required by the statute. The auditor has to do that work. The auditor has to comply with Auditing Standard No. 5 of the PCAOB. It has to do certain things. It has to ask for certain things. It has to get certain responses. If a company—if John is advising Frank to just ignore what the auditors are saying, I think as a practical matter that it is highly unlikely. There is a cooperative need to get the job done, and so there

is enormous pressure from this, so disclosure only is a very high level of theory. As a practical matter, it is a quasi-mandatory auditing system.

Mr. HILL. Yes. I thought that was a good exchange, and I thought it was helpful to get that in the record because there are many things that there is a bit of discretion in, but legal liability costs and abundance of caution err on the size of spending all the money and dotting every I, even if it is not totally prescriptively required. Another example of that is the accredited investor rule for a Reg D private placement. You are allowed up to 35 non-accredited investors in a Reg D private placement under the SEC rules, but I do not know anybody whose lawyer will facilitate that. You have strong external auditor improvements in SOX. You have strong CFO/CEO attestation in SOX, and now you have internal control requirements that were outlined in SOX, including the audit you suggest. So, we have been doing it for 20 years.

What about the idea for a less frequent audit required for even a large filer if they have a good track record and they have been in full compliance? What about the business judgment rule? Where is the audit committee in this? Do they not have some right to outline the scope for their audit? What are your thoughts on that?

Mr. CUNNINGHAM. Yes, I think you have identified some very important features of SOX that are often overlooked. The main culprit behind Enron was a very cooperative auditing firm in Arthur Andersen. All of those frauds were audited by that same firm. That same firm went out of business, went bankrupt, is gone, and is not part of the auditing culture today. So, Sarbanes-Oxley prohibited public auditing companies from providing non-audit services to their public audit clients. That was a huge change, and it is probably more important than any of these other things, and I do not have any notion that it is going to be changed. I think that is a very important change. The audit committee rules are extremely important. I think audit committees are much more effective, much more energetic, much more leaning in, and probably can be relied upon more these days. So, I think the excessive investment of resources into that internal control audit is really something that you all ought to focus on. It is, I think, the highest priority. It has created a culture of excess, and the primary beneficiaries are those same auditing firms who are no longer allowed to do non-audit.

Mr. HILL. Yes, there is no doubt this has been a nice revenue opportunity for that, but I think if you have the high standards of the C-suite officers, and the audit committee independents, and the rotation of the public accounting firm, and that discipline is put in SOX, then why could not an audit committee say we are going to do the audit of internal controls every 3 years instead of annually when it is such a box-checking exercise? I agree with you; I think audit committees are substantially improved than when they were in 2002, 2003. Quoting your pal, Warren Buffett, I mean, he was always arguing that the compensation committee ought to have a saber-toothed tiger as the chair, not a pussycat. I think that is true for auditing firms and auditing committees, and I think that has been a positive result from Sarbanes, but I think the compliance costs need to be reviewed. I yield back to the chair.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentlewoman from California, Ms. Waters, who is also the Ranking Member of our full Financial Services Committee. You are recognized for 5 minutes for questions, ma'am.

Ms. WATERS. Thank you very much, Chair Wagner. Professor Coates, as you know, Republican's so-called Big Beautiful Bill has a provision that would dismantle the PCAOB and move its functions under the SEC. The PCAOB is the crown jewel of the Sarbanes-Oxley Act of 2002, which was passed by Congress in response to a number of major accounting scandals in the early 2000s. The Republicans have done nothing to increase the SEC's budget, which seems to be the only way the Commission could continue the PCAOB's important work. The PCAOB is currently budget neutral as it funds itself by fees on public companies and broker-dealers, so the provision would not save taxpayers any money whatsoever. Furthermore, both the SEC and the PCAOB have confirmed to my staff, in writing, that the SEC is not a party to the agreements the PCAOB has in reach with foreign governments to inspect companies and auditors based in their jurisdictions.

Again, if we are shutting down the PCAOB, the SEC cannot inspect auditors in China or in many other foreign jurisdictions. Can you talk more about the potential disaster dismantling the PCAOB would be for investors and our broader financial markets?

Mr. COATES. Yes. Thank you, Ranking Member Waters. I am glad to hear in this hearing so far, no one on either side is proposing to abolish the PCAOB, even though that is what the budget bill would have done but for the Senate parliamentarian. I assume that it is because of a recognition of the points you are asking me about, that abolishing the PCAOB would save no money. In fact, I think it would actually increase the burden on the taxpayer because the transfer to the SEC would be an unplanned, unfunded, disastrous, overnight transfer. The SEC, where I worked, I know in Washington, it is actually a small Agency, but it is quite big and it has a lot of things to do, and for it to suddenly, overnight, take on the role of the PCAOB would be quite expensive as a matter of transition and certainly even more expensive without any planning. It would fail, and the result would be a return to, basically, lack of inspections with any kind of meaningful backbone.

The American Institute of Certified Public Accountants (AICPA), which is a perfectly excellent organization—my uncle was a CPA; CPAs are great—AICPA is a good organization, but it is not up to, nor was it in the 1990s, up to the task of checking the audit standards of the biggest audit firms for most public companies. If you abolished the PCAOB, I believe, or transferred significant authority to States or to self-regulation, you would see a resumption of bad audit practices. They would look the other way, not simply at controls, but at the basic financial statements that Professor Cunningham has emphasized so much, and you would, again, find a resurgence of restatements and, ultimately, of fraud.

That, by the way, would affect companies that are not fraudulent themselves. An important research finding that has been repeated several times is that when a company in an industry like biotech commits fraud, not only does it lose enormously when the fraud is revealed, but other companies in the same industry do as well.

Ms. WATERS. Wow. Furthermore, as I previously mentioned, the Sarbanes-Oxley Act—that is, SOX—was enacted in 2002 in response to a series of high-profile corporate accounting scandals, like Enron and WorldCom, which collectively cost investors billions of dollars and eroded public confidence in financial markets. Those scandals exposed systemic issues, like fraudulent accounting practices, conflicts of interest, and inadequate oversight. SOX passed with overwhelming bipartisan support, 423 to 3 in the House and 99 to zero in the Senate. Nevertheless, Republicans looking to fund a tax cut for billionaires have decided to eliminate this Agency without convening a single hearing and maybe looking to weaken the rest of the law that authorized it.

Professor Coates, you do not have time. I would like you to talk through some of the key tenets of Sarbanes-Oxley and why they have been so beneficial for investors and U.S. economies overall. Since we do not have time, we certainly hope that they will hold a hearing so that you could be able to talk more about why it is so important for us to have an independent PCAOB. With that, I yield back the balance of my time. Thank you.

Chairwoman WAGNER. Thank you. The gentlelady yields back. The chair now recognizes the gentleman from Oklahoma, Mr. Lucas, who is also the Chair of the Task Force on Monetary Policy, Treasury Market Resilience, and Economic Prosperity. You are recognized, sir, for 5 minutes for questioning.

Mr. LUCAS. Thank you, Madam Chairwoman, and thank you to our witnesses for testifying today.

We benefit from the deepest, most liquid capital markets in the world, and that is why it is important for us to always look at how we can improve access for everyone in the economy, so our markets stay strong, resilient and attractive. One of the challenges we face today is the prohibitive cost of going public: overreaching compliance requirements and reporting regulations that discourage companies from entering public markets. Dr. Allen, can you talk more about some of the disincentives that we should address so our public markets remain a viable option for companies to raise capital?

Dr. ALLEN. Thank you, Congressman Lucas. I think it is important to recognize that in any discussion of the cost and benefits to being public, our research highlights that those costs and benefits are not uniform across firms. So, what I take away from this hearing today and the bills that were proposed is a desire, which I commend, of the committee to investigate and think about carefully where the benefits are most likely to manifest for what type of firm, and to avoid prescribing costly regulation in places where those benefits are less likely to manifest and the costs are supposed to be higher.

In terms of the academic research, to your question on how firms enter and perhaps exit public markets, I am aware of an excellent academic study by Ewens and co-authors that was conducted last year, where they try to quantify the costs of being a public firm. They estimate that as a consequence of the JOBS Act, for example, which provided regulatory relief, roughly 28 more firms per year will go public, so there is something certainly to be said for that careful analysis. The flip of that, of course, is that there is also academic research that suggests, as Professor Coates has testified,

that there are benefits to investor confidence in the markets that may lead to more investment. So, I think careful consideration of those complex costs and benefits is warranted.

Mr. LUCAS. Mr. Watanabe, can continue to speak to your own experience about what challenges did you face as your company was growing and how can we ensure that our compliance reporting regimes are appropriately tailored to the size of business they regulate? Can you expand on that some more, please?

Mr. WATANABE. Yes, certainly, and I think to Dr. Allen's point, the JOBS Act and the lower thresholds for newer companies to go public were key to our decision to go public in 2020 and certainly facilitated that process. It is still a costly and cumbersome process, but it is a lot less costly and cumbersome thanks to the JOBS Act, and, even when we first went public, we were not subject to 404(b), right? We were 404(a), and there were considerable requirements on us as a 404(a) company as well. When we tripped into 404(b) the following year because of our market cap, as I mentioned before, there was a very significant cost increase associated with that, a doubling roughly in our audit fees and the additional cost of having compliance resources come in to design the internal control systems that were required for us to meet the standards of our auditors. That was money that I had to take out of the bank, effectively, to take my investors' money to spend on the auditors and the compliance resources, and it was money that I did not then have to invest in R&D.

Mr. LUCAS. Mr. Cunningham, you have studied the effects on business when Federal regulations are not well suited for present challenges. In your view, how can we modernize Sarbanes-Oxley in a way that maintains robust financial integrity while making our public markets more attractive to firms? Can we still protect investors while competing on the global stage? I would note I was here for and voted for the passage of Sarbanes-Oxley, but even the United States Constitution has required occasional adjustments to reflect the times. Could you touch on that?

Mr. CUNNINGHAM. Yes, thank you very much. I think investor protection and capital formation are the two objectives, and this hearing, I hope, will focus and is focusing on investor protection. I think several of the immediate steps that Frank has outlined would be very useful and that appear in one of the bills. So, raising the 404(b) exemption, and even Ranking Member Chairman Sherman has said we need to adjust those things for inflation, so that seems obvious. Averaging it over several periods would be a good idea, perhaps extending the emerging growth company period from 5 to 7 or 9 years, but overall, to refocus on the primacy of financial reporting, that is the information that investors need. The integrity of internal controls is a means to that end, and I think we have lost sight of that. So, if you can guide the PCAOB or the SEC to recalibrate, I think that would be extremely helpful.

Mr. LUCAS. Thank you, Madam Chair. My time has expired.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from California, Mr. Vargas, for 5 minutes for questioning.

Mr. VARGAS. Thank you very much, Madam Chair. I appreciate very much the opportunity and also the ranking member and all

the witnesses here today. I do not often quote President George W. Bush, other than for his malapropism for strategery—I did enjoy that one—but I do want to quote him when he signed the Sarbanes-Oxley bill in 2002. As the ranking member noted, it passed 423 to 3 in the House and 99 to zero in the Senate. He said this: "America's system of free enterprise, with all its risks and all its rewards, is a strength of our country and a model for the world. Yet free markets are not a jungle in which only the unscrupulous survive or a financially free-for-all guided only by greed. The fundamentals of a free market

—buying and selling, saving and investing—require clear rules and confidence in the basic fairness. The only risks—the only fair risks—are based on honest information." I think that is what Sarbanes-Oxley did, and I think what the rules here are.

Now earlier, Professor Coates, some words were put in your mouth that you said that this was optional. Is that what you said?

Mr. COATES. No, and to be clear, it is not a matter of theory that companies can choose not to do everything their auditors recommend. Ten to 20 percent of all public companies report material weaknesses in their control systems. Some of them report them year after year, so this is not just theory, this is actually borne out in practice. It is not, to be clear, my advice that you just ignore the auditors. That was not what I was saying, but, rather, that if they ask you to do something that you in your judgment can explain as too costly for the benefit, you have the ability to do that as long as you explain that to your investors. Now if you cannot explain it to your investors, then okay. Then I can see why you might want to then do it anyway, but then you have to ask yourself, if it cannot be explained, why exactly are you resisting? So, it is not optional in a general sense, but it absolutely provides companies currently with the flexibility to resist pressures by auditors when they think it is a bad idea.

Mr. VARGAS. Talking about flexibility then, let us stay on that issue for a second. You know, one of the best arguments, I think, that they make about some of these disclosure rules and the rest is there is a big company, there is a small company. The costs, they do not scale. You know, if you are a little company, you have to pay a million bucks. If you are a big company, you can absorb that easily. However, in 2007, when you were evaluating SOX, you said this: "Perhaps the most important component of the Sarbanes-Oxley was precisely to delegate power to the PCAOB so that it could customize rules and respond to feedback much more rapidly than Congress could do on its own." So, could it do that?

Mr. COATES. Absolutely, and I just want to emphasize, I think that the ideas that Mr. Watanabe sketched in his opening remarks are absolutely worthy of serious consideration. Some of them may be better than what we have right now, but to do it through a statute as opposed to doing it at the level of the PCAOB or, if necessary, at the level of the SEC, who can move more quickly to allow companies to respond to their auditors when they feel they are being pressured to do things they should not first, and then second, to carve out different kinds of companies from some of the requirements or to stretch them out, use averages, over 3 years. If it is a 200-person employee company, those, I think, are all fairly

taken, but they are things that can be done without changing the statute. All you need is a hearing where you bring people from the SEC and PCAOB over and say, what about these ideas, guys? Let us do these at the regulatory level.

Mr. VARGAS. Okay. Last, I do want to ask you about this because the world has changed, and we do have now other regulations in other parts of the world, and you said that there are similar regulations in other parts of the world. We are not the only ones here. We are not an outlier. Could you comment?

Mr. COATES. It is completely right. Following Sarbanes-Oxley, virtually every major economic political system adopted similar requirements. There is no observable regulatory arbitrage opportunity to move to, say, the Cayman Islands, or Bermuda, or France, or England, and raise capital there. In fact, the British, these days, are very unhappy about the fact that the biggest British companies are listing in the United States rather than in England because the combination of a strong regulatory system and deep capital markets reinforce one another and help capital raising.

Mr. VARGAS. Thank you, and last, I would just like to say this, a point of pride. I see that you are at Harvard. Thank God for Harvard. There are a number of us that went to school there, and we can proudly say it now. I hope you guys stick to your guns. Thank you.

Mr. COATES. We are the most popular we have ever been. It is amazing.

Mr. VARGAS. Yes, I know.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from Ohio, Mr. Davidson, who is also the Chair of the Subcommittee on National Security, Illicit Finance, and International Financial Institution. You are recognized, sir, for 5 minutes for questioning.

Mr. DAVIDSON. Thank you, Madam Chairwoman. Sarbanes-Oxley was born out of good intention in the wake of Enron's collapse but let us be clear: this statute is not sacred scripture which is not supposed to be added to or taken from. Even the Constitution, which might be the closest thing we have to something sacred in our own country, has been amended quite a lot. So the idea that, oh, how dare you amend the statute, I think it merits at least some consideration, and that is the point of this hearing, so thank you for convening it. It is clear that the burdensome compliance costs have crushed businesses, especially smaller ones that do not have the deep pockets to navigate this red tape. Frankly, some of the bigger companies view this as an opportunity. It creates deal flow because it creates regulatory barriers that, just to get to the next phase, might say it is easier just to go ahead and exit and sell.

As someone who owned and operated manufacturing businesses in Ohio, I know firsthand the struggle of juggling tight margins and deadlines and regulation. I empathize with smaller public companies facing duplicative audits mandated by Section 404. These regulations can choke innovation and slow growth for companies that are the backbone of our economy. With that, I have a letter from the National Association of Manufacturers that I request to submit for record with it.

Chairwoman WAGNER. So ordered.

[The information referred to can be found in the appendix.]

Mr. DAVIDSON. Thank you, Chairwoman. In this letter, National Association of Manufactures (NAM), who represents 13 million people in the manufacturing industry, takes aim at Section 404(b), which requires companies to hire an outside auditor to publicly attest to management's assessment of the effectiveness of the company's internal controls and financial reporting. This is in addition to normal audits. NAM's findings conclude that the costs far exceed the SEC's rosy estimates, hitting smaller public companies the hardest. After 2 decades of this regulatory overreach, it is time for Congress to act and free smaller firms from this unnecessary burden. It also supports why I backed today's noticed legislation to raise the revenue and public float thresholds for smaller reporting companies and adjust their filer category transitions. This is a commonsense step to let businesses focus on creating jobs, not feeding bureaucracy.

Mr. Cunningham, you have highlighted how SOX 404(b) disproportionately hit smaller companies. Can you impact the real-world impact of these regulations, and how can we scale it back?

Mr. CUNNINGHAM. Thank you very much. You have heard a lot of testimony today about the extraordinarily hard hit that small companies take from this because the costs do not scale, and the costs are substantially duplicative because an audit of financial statements requires an examination of the controls and a testing of the controls. So, I think the cost benefit is quite out of whack, and I think Congress is right: it is Congress' responsibility to update and review its statutes, not just to delegate to agencies.

Mr. DAVIDSON. Yes. That was, in fact, the finally hard-fought win in the Chevron deference case in the Supreme Court. So, in the wake of that, it creates an even bigger burden for Congress to act, so thank you for that. Dr. Allen, I agree with your statement that for early lifecycle firms, diversion of resources and innovation hindrance are notable effects, maybe not the intent, but certainly the effects of Sarbanes-Oxley's regulatory regime, the impact on cash-flow and everything else. Could you just discuss from an entrepreneurial perspective what modernization of SOX could do for industry?

Dr. ALLEN. Yes, so thank you. It is important that our research acknowledges that this is not just a small firm effect. It is very similar from the standpoint of the costs and benefits manifesting differentially, but it is a different type of group. When we think about these highly innovative companies, the challenge is that although one set of controls is not mandated, as Professor Coates has articulated very well, there is often a compliance mindset that is very rigid in form. I worked at Mattel when they were in the early stages of implementing their SOX 404, and essentially, they hired out another audit firm to help them design what would be the appropriate controls, which then would pass for another audit company as it was very standard practice to have consultants help. While a firm can disclose an internal controls weakness, my understanding is that recently, the SEC has communicated with firms that it is inappropriate to just let those sit over time, that the objective of controls is to move forward, to remediate controls as to ensure financial reporting quality. So overall, what happens to

firms, I think, as the audit comes in, is that it imposes a mindset or a structure that, again, is pushed more toward centralization, formalization of processes that are deconstructive or devaluative to the exploratory innovation process for this particular firm subset.

Mr. DAVIDSON. Yes. Thank you for that, and I will just close by saying I appreciate your nod to the late Thomas Sowell in your written testimony. So with that, I yield back.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from Illinois, Mr. Casten, for 5 minutes for questioning.

Mr. CASTEN. Thank you, Madam Chair. Thanks, witnesses. So not for the first time this term, I feel like we are sort of here in, like, a British Bake Off competition, and our contestant has served up a giant horse manure cake, and we have brought you in to opine on the quality of the flour. We have a markup here. One of the bills we are marking up is looking at auditor independent standards of the PCAOB, even as we have a budget that would eliminate the PCAOB. We are sitting here talking about the nuances of audit standards, even as this committee has voted to exempt entire industries from any kind of a disclosure-based regulatory regime. I say that not to criticize any of your expertise as grain millers, but I would like to talk about the dung cake. I am pushing that metaphor as hard as I can, but bear with me. I am at least making a smile.

Mr. Watanabe, I read an interview with you in 2021 where you talked about your process of taking your company public. You said that one of the benefits of the IPO process is that law firms, accountants, investors do an excruciating amount of due diligence in the company. Everybody knows what they are investing in. Transparency and integrity are important when money is involved. I hope you still agree with those statements.

Mr. WATANABE. Yes.

Mr. CASTEN. In that context, would you agree that audited financial statements are critical to make sure that we have public confidence in markets and so that people know they are efficiently allocating their capital?

Mr. WATANABE. I certainly agree with that, but I would also point out that I had to have audited financial statements when I was subject to Section 404(a) as well.

Mr. CASTEN. No, no, understand, and, again, like, I am not criticizing like that there are different qualities of flour. I am just saying we are talking about audit because the Congress right now is drafting stablecoin legislation, the idea that you could buy some piece of computer code that is neither stable nor a coin, but you could buy this piece of computer code, and in exchange for buying that code, it is redeemable for $1, and yet, the Senate just passed a bill that said that unless you have $50 billion in assets or more, you are not required to have an audit. You just have an attestation. So, you could shuffle money in on the 29th day of the month, shuffle it out on the 30th, take a snapshot, and that qualifies. It is like running a casino and having your dad buy $3.4 million of tokens and using that to disguise whether or not you had a solvency problem.

Mr. Coates, considering that stablecoins are sold to retail participants, used for investors, if my Republican colleagues are right, are going to be tightly integrated into our financial system, do you think they should be subject to audit standards like banks are, like public companies are, or is an attestation sufficient?

Mr. COATES. I would have thought that we as a country and as an economy learned that lesson in 1934, not recently, audits are foundational for financial investment. My mother-in-law, bless her heart, does not understand that and has, on occasion, fallen for illegal unregistered securities offerings by people who do not get audits and have lost money. So a stablecoin product, as framed by the so-called Guiding and Establishing National Innovation for U.S. Stablecoins (GENIUS) Act, would extend the capacity of, let us call them entrepreneurs for politeness, to take that and make it perfectly legal.

Mr. CASTEN. Let me——

Mr. COATES. I think it is terrible.

Mr. CASTEN. Let me say, and look, you are generous saying 1930s. We have a White House that seems to have fallen in love with 1890s economic policy. Stay on that for a second because it is insane that we had an amendment to put audit standards in that was voted down by all the Republicans in this committee. There is recent news that Justin Sun, who is one of the many committers of emoluments violations, has provided a bunch of money to the President of United States to bail him out of World Liberty Financial, got to go and have the crypto dinner, that he is now trying to do a reverse merger to take his crypto company public in the United States that would allow him to access public IPO markets without having to go through the kind of disclosure that you went through before doing an IPO, Mr. Watanabe. So, I guess, Mr. Coates, could you talk about some of the concerns that happen through the reverse merger process, particularly with foreign entities of concern that might be able to access public markets with lower disclosure standards?

Mr. COATES. Yes. It is well established that even when companies that are subject to full regulation and audit use the reverse merger process, they are more prone to fraud, more prone to misreporting than companies that go through a fully underwritten process, and as annoying as the underwriters can be during the process, sometimes they really do perform a very valuable service, not only to the investors, but to the company if it is a long-term company that has real future to it. So reverse mergers, bad signs, and the idea of removing regulation from the process of doing that, even less good idea.

Mr. CASTEN. I am out of time. I yield back but let us just stay focused on the fact that audits are important. The details of an audit, we can talk about later. I yield back.

Chairwoman WAGNER. The gentleman's time has expired. The chair now recognizes the gentleman from Wisconsin, Mr. Steil, who is also the Chair of the Subcommittee on Digital Assets, Financial Technology, and Artificial Intelligence. Sir, you are now recognized for 5 minutes for questioning.

Mr. STEIL. Thanks, Chair Wagner. Thanks for being here. Thanks for the dialog on an important topic. I want to start with

you, if I can, Mr. Frank Watanabe when it is "Style," it is "Steel," but it is good, but thanks for being here. You built out a great company, grew a dermatology biotech company from a handful of employees to a large, publicly traded company. I want to focus in particular in your experience leading a startup through that process. Mr. Liccardo and I have legislation to extend the EGC

—Emerging Growth Company—onramp for certain companies so that they do not age out of EGC status before reaching maturity, and I appreciate you expressing support in your testimony for that today. I just want to ask you to put a little color on that, to talk about how your business, in particular, benefited from EGC status and the implications that would have occurred if you had lost that status too soon.

Mr. WATANABE. Yes. So when we went public, we were probably about 100 people in the organization, and vast majority of those people were involved in researching our products or manufacturing our products. Having the emerging-growth company status allowed us to do our IPO given that size because their requirements are clearly lower as an emerging-growth company, and we enjoyed that benefit for a couple of years as well. I think if the JOBS Act had not passed and that pathway had not existed, the cost for us, the complexity for us to have gone public would have been substantially greater, and we very well may have reevaluated our decision to go public. Now, we lost that status as time went on.

Mr. STEIL. When you did lose that status? What did you see as an implication on your compliance costs?

Mr. WATANABE. I would say losing the EGC status probably was less of an implication than 404(b). 404(b) is really the thing that we saw the most significant implication for us in terms of compliance costs. I think I mentioned earlier my testimony, it has more than doubled the cost of our compliance activities at our——

Mr. STEIL. In real-world terms, that takes it from, like, $5 million to $10 million. What does double mean as we kind of think about this for companies of your scale?

Mr. WATANABE. Sure, sure. So, the year before we triggered 404(b), we spent about $650,000 on our audit, and we did not have an external compliance provider. The year that we fell into 404(b), those doubled to $1.1 million in 2021. As I mentioned, last year, it was $2.2 million, which was up 24 percent the prior year. We are expecting something like that this year in terms of an increase as well.

Mr. STEIL. Let me hit one additional topic. Commissioner Peirce said, I think, "The process of determining whether a company is a smaller reporting company (SRC) and a non-accelerated filer, or an SRC and an accelerated filer, or even outside of both categories, so complicated that even we at the SEC need diagrams to figure it out." Can you just comment on the complexity of that system?

Mr. WATANABE. One of the challenges, and I suspect that quote refers to, is that there are different standards for different things, and so you can be an SRC and an accelerated filer, for example. So, I think to the extent that those triggers are harmonized across different regulations or legislation, whether it is the SEC or PCAOB or Congress that does it, I think that would be a very positive step, because you can——

Mr. STEIL. I agree with you. I think we have room to clean that up. I have about 75 seconds left, and I know you uniquely were impacted by proxy advisors. I think this duopoly of Institutional Shareholder Services (ISS) and Glass Lewis is atrocious. It is maybe just a step beyond the topic of this committee but hit me with what ISS and Glass Lewis and the proxy advisor duopoly did to you.

Mr. WATANABE. Well, I think we have struggled with several things when there have been factual inaccuracies, and our inability to review their reports on us in advance is a problem so that we cannot correct them.

Mr. STEIL. So, they just put out the information——

Mr. WATANABE. And it is——

Mr. STEIL [continuing]. and off people go voting, and you do not even have a chance to raise your hand and say that is not true.

Mr. WATANABE. That is correct. We have to fix it on the back side. The other issue is that they have a set of standards that do not align, for example, with the SEC's own standards for things like independence, and that has been an issue for us.

Mr. STEIL. Because they are not fully regulated under the SEC in a manner that you and I probably think that they should be, right?

Mr. WATANABE. They are not really regulated at all, yes, and it is the Wild West. In the ESG area, they will pay you to tell you how to improve your ESG score, so there is a clear conflict of interest.

Mr. STEIL. The conflict of interest is they claim there is a Chinese wall, that this side of the entity is going to take the money, this side is going to report, but do not worry, there is no talking between those two. We are out of time. I appreciate your testimony. Big opportunity on proxy advisors. Yield back.

Chairwoman WAGNER. The gentleman yields back. The chair recognizes the gentleman from Massachusetts, Mr. Lynch, for 5 minutes of questioning.

Mr. LYNCH. Thank you, Madam Chair. I thank the witnesses for your help today. It was earlier said that Sarbanes-Oxley is not sacred text. Now that is very, very true, but let us be clear, though. I served on this committee back in the early 2000s and witnessed the collapse of Enron and WorldCom and Tyco early in the 2000s. These high-profile corporate accounting scandals collectively cost investors billions of dollars and eroded public confidence. It really created a crisis here. The fall of Enron alone cost about 20,000 jobs. It was a scandal and more than $2.1 billion in retirement assets. People were talking about bailouts and, as well, about $67 billion in losses for shareholders. So, the scandal-exposed systemic issues in corporate accounting, including a lot of fraudulent accounting practices, those accounting firms were being purchased by their clients to give misleading audits of their companies, and as a result, this committee passed the Sarbanes-Oxley Act. Any time you get 400 votes in the House for a bill, that says something, and when you get 99 to zero in the Senate that says something. This was a crisis.

Sometimes, they say it takes a crisis to get Congress to act, especially in unison, in a purposeful way. We had a crisis back then.

The bill created the PCAOB, the Public Company Accounting Oversight Board, whose primary purpose was actually to get at those audits and to stop the fraud, and that is what it does today. I want to be clear: this hearing is not tweaking the PCAOB. It eliminates it. It obliterates, to borrow a phrase, obliterates the PCAOB. It goes away. The funding for that function of making sure that the audits are accurate, the funding for that goes away. Mr. Coates, can you talk about that? So, Section 50002 of the reconciliation bill, basically, like I said, obliterates the PCAOB and the funding stream that supports the auditing function that this not-for-profit corporation, the PCAOB performs, and what do you think the result of that is going to be for people who rely on those audits?

Mr. COATES. I firmly believe that the investment community would, with growing speed, cease to believe that audited financial statements actually represented what they purport to represent. It would increase the cost of capital for every small-and medium-sized company that wants to raise outside equity capital. It would harm the American economy. I have no doubt about that.

Mr. LYNCH. Yes. One of the other red flags I see is that the Trump Administration, with respect to the SEC, which is where I guess some of this responsibility would flow, the Trump Administration also opposes the SEC fiduciary rule, which basically says financial advisors have to act in the best interest of their clients, so, I mean, there is a direct attack on financial advisors' responsibilities to their clients. They want that to go away, and, I mean, there are other firms out there that actually lean into fiduciary duty. You got firms out there that are doing really, really well, that say, you know what? We are a fiduciary. We accept and we are proud of our responsibility to act in the best interest of our clients. Yet the Trump Administration wants to get rid of that, and they want to get rid of the PCAOB. They want to defund the Financial Protection Board. That has been rejected, I guess, by the parliamentarian over in the Senate, but collectively, these aggregate attacks on responsible regulation, successful regulation is really problematic, but it does show, it does reveal the attitude of the White House in this matter. Thank you. I yield back.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from Indiana, Mr. Stutzman, for 5 minutes of questioning.

Mr. STUTZMAN. Thank you, Madam Chair, and I would like to submit a letter from the American Securities Association to the committee for the record.

Chairwoman WAGNER. So ordered.

[The information referred to can be found in the appendix.]

Mr. STUTZMAN. Thank you to all of the folks here for testifying today. This is a really important issue, especially for businesses across the country. My previous career or service outside of public service in the private sector dealt with startup companies, turnaround companies, but also publicly traded companies, and there are a lot of companies out there, people that are investing in their local communities, creating jobs that want to grow and want to give back to the community, give back to their shareholders, create wealth and new opportunities. So, I think that this committee hearing is really critical for the growth of our country.

While we know that Sarbanes-Oxley was intended to prevent fraud, over the past 20 years, we have seen the negative impacts of these regulations on growing companies and their access to capital. The cost and regulatory burden of these requirements are excessive as even small companies, as I mentioned, must pay, on average, $723,000 a year to comply with this act. These costs have deterred small companies from going public, which I experienced personally, gaining access to capital and propelling economic growth. The median age for a firm seeking an IPO increased from 6.9 years in 2014 to 10.7 years today. I had a business attorney tell me that if you wait 10 years, you will become an overnight success, and that seems like what is happening today because of the regulatory environment.

Dr. Allen, I would like to ask you, in your testimony, you cited research finding that firms tend to manage their public float downward to avoid exceeding the $75 million and $700 million regulatory market cap thresholds for qualifying as accelerated and large accelerated filers, respectively. How much market valuation are firms willing to sacrifice in order to avoid having to comply with SOX?

Dr. ALLEN. Thank you, this is the Ewens study that I was citing here. They estimated that for firms just below the $75 million threshold, they are essentially willing to pay $132,000 annually to stay below that threshold, or give up about 1.8 percent of their market cap. For firms seeking to avoid the $700 million threshold, the equivalent is more like $900,000 per year in costs that they are incurring and giving up about 1.2 percent of their market cap. The way they stay below the threshold is that they shift their financing toward debt and away from equity.

Mr. STUTZMAN. Yes. No, that is right. So, is managing float downward a concerning trend for you, and if so, does not lower stock float typically lead to higher volatility in the stock's price because it is easier for a smaller number of shares to move the price?

Dr. ALLEN. We do have some evidence of that from outside of U.S. markets. I do not know that we have tested it specifically in the United States, but, yes, anytime we see firms incurring real cost to manage their market cap, it suggests that they at least perceive that the net costs are heavier than the net benefits.

Mr. STUTZMAN. Yes, very good. Mr. Cunningham, going back to the compliance barriers, could you speak to that and how it is hurting American communities, like I mentioned, those in my district, smaller companies? Maybe it is manufacturing, maybe it is tech, great ideas. We have a large orthopedic sector in Northern Indiana as well. How does that affect them because I know for a fact, I mean, it is hard to go public. It is almost easier just to build the company up and sell it to a publicly traded company, or do a Special Purpose Acauistion Company (SPAC) and just go in backward, which has its challenges as well.

Mr. CUNNINGHAM. There are real costs to communities of overregulation, and especially there is over-auditing of internal controls. It is exceedingly expensive and prohibitive for many companies. Every entrepreneur is going to assess the costs and benefits of sourcing capital, deciding whether to stay private or access to public capital markets, and there is no question that there are sig-

nificant costs, significant barriers, and so businesses in your district and other communities across America are certainly adversely affected by this. So, I commend you and the committee for focusing attention on it.

Mr. STUTZMAN. Well, there needs to be a balance, but it seems like we are too far to the one side, and, ultimately, it is money going to the government versus money going back into building a business or going to shareholders and generating more velocity in the marketplace. Thank you for your testimony. Madam Chair, I yield back.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from Louisiana, Mr. Fields, for 5 minutes of questioning.

Mr. FIELDS. Thank you, Madam Chairwoman, and let me thank all the witnesses for being here today. I just have a few questions, first, to Mr. Coates. Following the devastating Enron/WorldCom scandal that costs investors billions, can you walk us through the specific failures that SOX was designed to actually address and what measurable improvements and audit quality and financial reporting reliability we have seen since the PCAOB began its oversight ward?

Mr. COATES. Thank you, Congressman Fields, for that. My written testimony refers to scholarship. I have published on this, and that will give you a much more comprehensive answer than what I am going to summarize, but I will say a couple of things.

First, to reiterate, before Sarbanes-Oxley, there was no PCAOB. If you have no PCAOB, then you have audit firms self-regulating whether they do a good job of the basic audit of financial statements. In the period leading up to Sarbanes-Oxley, they failed over and over with increasing frequency, in part because of another thing Sarbanes-Oxley changed was they were, at the time, permitted to engage in significant non-audit work for the same company they were auditing. They were, in effect, partly auditing themselves, and they were being paid lots of money for the overall relationship, which meant that they were less inclined to fight hard during the audit. That led to a dramatic increase in the number of mistakes and of fraud.

You can just see to the numbers they were going up and up every year through Sarbanes-Oxley. Once the PCAOB's audit standards kicked in, they began to decline, and they have remained at much lower levels over the past 10 years. It never gone to zero. It is not like the PCAOB is perfect. Sarbanes-Oxley is not perfect. We are never going to get to perfect, but it has significantly improved financial reporting quality. As my colleague down the bench here has shown in her work as well, it is not just me, it is consistently found better reporting quality as a result of audit standards.

Mr. FIELDS. Thank you. Dr. Allen, from an academic standpoint, what evidence do you see that the current independent PCAOB structure is more or less effective than following these specialized functions into a broader SEC mandate, and how would you assess the risk of diluting these focus on expertise across the SEC's much wider regulatory responsibilities?

Dr. ALLEN. Thank you for the question. My own research has not looked into the PCAOB. I think certainly points that have been

raised regarding funding and independence are important questions to assess when thinking about who will perform these functions. As Dr. Coates has mentioned, we do see a drop in restatement rates following the implementation of the PCAOB, but it is also correspondent to a time when we saw the independence rules for auditors changing, which was an important shift as well. So, research of examining the strength of those two forces would be important to understanding what is going on there. That would be my assessment of current research.

Mr. FIELDS. Thank you, and my final question is to Mr. Cunningham. Section 404, internal controls assessments have been criticized as costly, yet they require companies to establish and maintain systems to prevent fraud. In your view, what would be the market-wide implications if we signal to investors that we are prioritizing compliance cost reduction over fundamental fraud prevention mechanisms?

Mr. CUNNINGHAM. I think the signal to markets and to investors of this review would be to signal that Congress is attentive and concerned about making sure that resources are deployed in ways that protect investors and are not deployed in excessive resourcing on internal controls. I would just add on 404(b), Dr. Allen is right that SOX made so many changes, it was very difficult for a long period of time to determine the effect of particular provisions. You know, we banned conflicts of interest and have good audit committees, officer certificates, and these internal controls. After the SEC increased the exemptions under 404(b) in 2020, we have empirical research on whether the quality of reporting went down or internal controls.

Mr. FIELDS. I want to thank you. I am out of time. I want to yield back to the chair. Thank you.

Chairwoman WAGNER. The gentleman's time has expired, and the chair now recognizes the gentleman from Montana, Mr. Downing, for 5 minutes of questioning.

Mr. DOWNING. Thank you, Madam Chair, and thank you to the witnesses for being here. As a recovering regulator, this is a very interesting topic to me. I was formerly the Commissioner of Securities and Insurance for the State of Montana, and I firmly believe that the best way to evaluate any regulations is to determine whether the benefits outweigh the costs. I am happy we are having this hearing on Sarbanes-Oxley, a law that Congress has not changed since 2002. I am going to start with Mr. Watanabe. You have spoken a lot on the subcommittee about the many barriers that companies have going and staying public, and I think about compliance costs a lot. So, all the compliance costs that public companies face, where would you rank SOX in those costs?

Mr. WATANABE. I think that the thing that I can quantify most clearly is the cost differential between 404(a) and 404(b), and I think I mentioned in my testimony earlier, we have spent about $11 million complying with 404(b) since we started being subject to it, and to quantify that is the cost of me running a phase 2 efficacy trial on a new drug, right? That is money that I did not have to spend on developing another new drug to treat another serious disease. When we were under 404(a), I still was subject to audit every year. I still had to sign the attestation every year. I think about

it every quarter very carefully, as I know you did, Congressman, as an entrepreneur. I do not look good in orange, right? So, I take that very seriously. So, it is not that I am suggesting a lack of regulation. I think it is really more titrating the regulation so that smaller companies are not overly burdened with the cost of compliance in the same way that a gigantic, multibillion dollar corporation is.

Mr. DOWNING. Thank you. I am going to move to Mr. Cunningham. Some contend that any serious reforms of SOX will lead to more corporate accounting scandals like Enron. In 2020, the SEC amended the accelerated filer and large accelerated filer definitions to carve out some smaller issues from the 404(b) requirements. Have you seen any decline in the quality of financial statements from these companies since this change?

Mr. CUNNINGHAM. Thank you very much for that question. I have not, and indeed there is empirical research by independent professors demonstrating that there was no adverse effect on the quality of the reporting or the strength of the controls.

Mr. DOWNING. Well, would you not say that proves that Congress can make necessary and targeted reform without jeopardizing audit quality?

Mr. CUNNINGHAM. Yes, sir.

Mr. DOWNING. Thank you. Many public companies see the 404(a) and the 404(b) requirements as duplicative auditing. Is there any way to reform these requirements to reduce this duplicative auditing while maintaining investor confidence? For example, why not just keep the 404(a) requirements in place?

Mr. CUNNINGHAM. Yes, I support this avenue of inquiry. I am glad Professor Coates agreed that we should consider many of the proposals that Frank has suggested and this committee has suggested. So, I think it is eminently within the scope of Congress' jurisdiction to tackle that and not give it over to the SEC or PCAOB.

Mr. DOWNING. I appreciate that. Are there any essential provisions of SOX that you think have worked as intended and do not need to be reformed?

Mr. CUNNINGHAM. I do think that the audit committee regulations, I was first quite skeptical of the very prescriptive and intrusive approach, but on reflection over the years, I think the audit committees are now leaning in very effectively, and so I think I would be satisfied with that. The officer certifications, I think, have heightened the attentiveness of leadership, and the ban on conflicts of interest with the auditors, I think that was the most important and successful accomplishment of the statute. So, there are quite a few good things, but there are a lot of missteps.

Mr. DOWNING. Right. Right. I appreciate that, and, again, just going back to this inquiry of understanding whether the benefits are worth the cost. I appreciate you all being here, and on that, Madam Chair, I am going to yield.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from California, Mr. Sherman, the Ranking Member of the Subcommittee on Capital Markets. You are recognized for 5 minutes for questioning.

Mr. SHERMAN. It is hard to know how much to invest in making sure that audits are accurate and that fraud is avoided. Reminds

me of a bank that had a bank guard there that said, hey, well, we have not had a robbery in 20 years, might as well fire the bank guard. You do not know until you find out. The harm of Enron and WorldCom, and I think Mr. Coates has pointed this out, is not just to the individual companies and their employers and their stockholders, but entire industries and the market overall. With Enron, I take it very personally because they also destroyed my State for several months by creating an artificial shortage of electricity and artificial blackouts when we had plenty of electric-generating capacity. Also destroyed a Governor of my State.

There has been discussion of the proxy advisors. I am concerned that they also offer advice on how to get a good score, but as to complaining that right before there is going to be a vote, somebody could publish something that affects how people vote, and it might be a duopoly. Well, welcome to my world. The LA Times publishes things right before a vote. They do not let me see it in advance, and maybe it is a duopoly because we also have the Los Angeles Daily News, but it is at most a duopoly. We have to explore the scope of what is required under Sarbanes-Oxley. I think people have mentioned the frequency, but I think the quarterly and annual are probably the right frequency, and then most of this hearing is focused on who is exempted. We exempt on the basis of dollar thresholds, which tend to focus on the equity that is out there, but, Mr. Coates, do not public bondholders also rely on these financial statements, and is there any reason to exclude the publicly held debt when we are also looking at the publicly held stock in disturbing these thresholds?

Mr. COATES. So the current exemptions, some of which are built into statutes, are crude, as you just noted, equity is not the only source of capital. Outside equity investors are not the only ones relying on financial statements. They could be more carefully designed. I want to emphasize, however——

Mr. SHERMAN. Yes. Let me move on to another question. Does the PCAOB or the SEC have the authority under current law to make some of the adjustments we are talking about, because there is an argument that these are arcane details that perhaps regulators can deal with better than us or at least more frequently.

Mr. COATES. More frequently, more quickly, and they can monitor——

Mr. SHERMAN. Do they have the authority under present statute?

Mr. COATES. They absolutely do. The one exception, this is something you guys could consider, letting them more carefully design experiments with their regulations. Currently, they are constrained to do that. I think you could consider giving the SEC the authority to test and then quickly change——

Mr. SHERMAN. One thing that failed the test was the structure of Arthur Andersen. When I was doing audits, you had the audit partner, whose job it was to golf with the CFO, and the technical review department. Arthur Andersen had a do not ask/do not tell approach with their technical review department. I do not think any accounting firm has replicated that, but is it clear that under current regulations, you have to have a technical review department inside the accounting firm sign off whether the audit partner wants that or not?

Mr. COATES. Thanks to the PCAOB and its standards and its inspections, audit firms routinely avoid that kind of cabining of information that helped trigger Enron, yes.

Mr. SHERMAN. Then one of the proposals, and the one I think I like least, is the idea that the auditor would not have to register with the PCAOB, but, rather, just meet the standards of the AICPA. As I pointed out, the AICPA was not consulted on that bill. I saw with Madoff that maybe the auditor was in technical compliance with the AICPA standards but was manifestly incapable of doing the audit. They had a couple of CPAs, and Madoff had a big empire to audit. What are the downsides of not having the audit firms be approved by the PCAOB?

Mr. COATES. I do not think we want to return to the Bernie Madoff scandal, so, no, it would not be, in my opinion, a good idea.

Mr. SHERMAN. Thank you.

Chairwoman WAGNER. The gentleman's time has expired. The chair now recognizes the gentleman from Florida, Mr. Haridopolos, for 5 minutes of questioning.

Mr. HARIDOPOLOS. Thank you, Madam Chair, and I first want to submit a letter from the Society of Corporate Governance regarding scaling disclosure and obligations for the record.

Chairwoman WAGNER. So ordered.

[The information referred to can be found in the appendix.]

Mr. HARIDOPOLOS. I also want to thank the chair for bringing this issue forth. As a new member of the committee, it is very helpful to understand the history and hear from the experts in the field about a bill that is over 20 years old and some of the changes that have taken place in our society since. I think one of the things we have talked a lot about in this committee is the power of the blockchain and the power of technology in general so that more people could put their eyes on things, so that when bad things happen, we can be alerted earlier as opposed to later on so many different subjects.

One of the issues, Mr. Watanabe, if you could, you have mentioned this term a couple of times: 24-percent increases. Are these prices that you are getting from your lawyers and accountants and so forth that are going through these records, or are these new rules that are being instituted each year and year out that force you to hire more accountants and lawyers?

Mr. WATANABE. Thank you for the question. The 24-percent increase that I mentioned was a year-over-year increase in the fees charged by our auditors. You know, it is not something that I have a lot of negotiating leverage with. My shareholders appoint our auditors annually at our annual general meeting, as I think all public companies do. Once our auditors are in place, they look at the scope of work and they tell me how much it is going to cost me, and it goes up quite a bit every year. It has more than doubled just since we fell into 404(b), so the costs go up every year, and the company has really no ability to negotiate those fees.

Mr. HARIDOPOLOS. Thank you, and, Dr. Allen, if I could, with your question. We have heard the testimony today. You live this. Clearly you understand this better than most. If you had a magic wand and pick one item that could be changed within Sarbanes-Oxley to still have the oversight that we are all looking for, but

also looking at the everyday costs that businesses are trying to make the decision, do they go public, do they stay public, do they sell to a different public company if they are a private company, all these things in place. If you had a magic wand, you could say, here is one change I would make to keep the oversight in place but reduce some of these costs so the companies might go public who are making these difficult decisions, what would you use as that magic wand?

Dr. ALLEN. Can I give two things?

Mr. HARIDOPOLOS. Sure.

Dr. ALLEN. One, I really like the idea of rolling averages because I think it is very hard for companies to come in and out of exemption status, and two, it would be more granular regulation that allows for thoughtful exemptions based on things like low revenue where we have lower risks or high innovation environments where control environments are more damaging.

Mr. HARIDOPOLOS. Mr. Cunningham, same to you. Do you agree with Dr. Allen? Are there other issues that are out there that you think is not the magic bullet, but at least try to reduce some of these 24-percent costs or change the way we are doing business from 23 years ago?

Ms. CUNNINGHAM. I agree with Dr. Allen, and so that means I get three. I agree with Chair Hill, too, his idea of having, instead of an annual test, have it every second year or every third year depending on risk profiles, complexity of the company, development stage, revenue, and so on. I think that is a worthy topic.

Mr. HARIDOPOLOS. Mr. Watanabe, do you want to add to that as well?

Mr. WATANABE. I would agree with all three of those.

Mr. HARIDOPOLOS. Mr. Coates, you made some good statements today. I want to give you an opportunity, too. You have obviously seen this law in effect for 20 years. There has got to be some issues where we thought it was a great idea in 2002, but maybe it has either outlived its usefulness, or technology has allowed us to look at things more quickly as opposed to the paperwork shuffle from 20-odd years ago.

Mr. COATES. I think the most important thing that this body could do is bring the PCAOB and SEC folks here and push them on the kinds of suggestions that you have just heard about because I do think they can do it more quickly. If they get it wrong, suppose they titrate too far one way or the other, they can reverse that more quickly than Congress can as a body. So, I would have a hearing specifically on some of these specific ideas. That would be the natural next step.

Mr. HARIDOPOLOS. Madam Chair, I appreciate the opportunity, and I yield back.

Chairwoman WAGNER. The gentleman yields back. The chair now recognizes the gentleman from Texas, Mr. Sessions, for 5 minutes of questioning.

Mr. SESSIONS. Madam Chairwoman, thank you very much. I think you did an awesome job to gather together people that do not compete against each other but have a same or similar story to tell, and I applaud you for doing this.

Mr. Coates, I will be quite blunt. I like where you come from, and your value-add to today is not an answer. It is giving the regulatory bodies the opportunity to come and, in essence, work with companies on some negotiation about what they will do. This is important because Mr. Watanabe's testimony, page 3, says the compliance cost for emerging growing biotechs, on average, is $800,000 a year. Then you go on and actually list what that price tag costs you in research and development to bring your clear biotech ideas that may save lives, may fix problems, may be a breakthrough. We are spending time on compliance costs rather than doing those things. I note Dr. Allen spoke well about this. Mr. Cunningham, very impressive, and I do not think that it says something somewhere and delete something later, but I do find that you have tried to focus the activity, off of, that compliance costs can have significant effects for firm IPO decisions, and so I would like to go at that level as opposed to beginning, middle, end, how big they are.

It is causing people who actually are business leaders and entrepreneurs, who want to get something to marketplace, that are worried about the FDA, that are worried about an FDA trial, that are worried about something else, and they are having to worry about am I saying everything right? Am I getting exactly what it does or not do, my biotech company, or otherwise? I just think, Mr. Cunningham, Dr. Allen, if you take just a minute, which is all I have left because I spoke too long, what do you think about Mr. Coates' idea of us using this tape of this hearing that Congresswoman Wagner has been really good at narrowing down and going to regulators and saying we charge you with trying to come up with a plan, not picking winners or losers, but by picking things, and they could strike that balance? Dr. Allen?

Dr. ALLEN. I support the idea that Professor Coates had put forward of consulting with the SEC, with members of the PCAOB, to think about the costs and benefits and how they differ across firms. I think, also, as he suggested, some level of experimentation. It is very hard to calibrate standards appropriately on the first go, so an openness to trying it, examining the data, and revising is good policymaking.

Mr. SESSIONS. Then making sure you hold them accountable, but there is a variance that is allowed there. Mr. Cunningham, one of the statements that has been made is time. When I was at Southwestern University taking my business classes, we learned time is money. Well, Mr. Watanabe would also say time is also people's lives, delaying things because you are having to shift. Tell us about the flexibility that you should be given, that these companies should be given by the regulator.

Mr. CUNNINGHAM. I think that is an excellent point, and it would be prudent I think for this committee—I do not mean to tell you how to do your job—but to have the SEC here, have the PCAOB here, and to give an accounting of their perspective, what they see the cost-benefit matrix, and develop strategies for right-sizing and balancing. I think that it would be a very productive thing to help address the lost time due to red tape, due to excessive resourcing into the internal control environment.

Mr. SESSIONS. We care very much, as well do you, about an investor who could be duped into the wrong thing, but I think almost

anybody that has money to invest, I would like to think, would recognize that getting to the FDA trial is the plus or minus. That is the go or no-go for lots of these things. Madam Chairman, this is, in my opinion, the best hearing you have had. I remain confident that we can make a difference, that we have built an argument that is available on a bipartisan basis, and you have proved it with your committee here today. Thank you very much. I yield back my time.

Chairwoman WAGNER. The gentleman's time has expired, and I would like to thank all my colleagues for their robust participation today. I want to thank our witnesses for their testimony today.

Without objection, all members will have 5 legislative days to submit additional written questions for the witnesses to the chair. The questions will be forwarded to the witnesses for their response. I would ask the witnesses to please respond no later than July 30, 2025.

[The information referred to can be found in the appendix.]

Chairwoman Wagner. This hearing stands adjourned.

[Whereupon, at 12 p.m., the subcommittee was adjourned.]

APPENDIX

MATERIALS SUBMITTED FOR THE RECORD

Charles Crain

Managing Vice President,
Policy

June 24, 2025

The Honorable Ann Wagner
Chair
Subcommittee on Capital Markets
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Brad Sherman
Ranking Member
Subcommittee on Capital Markets
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Re: Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets.

Dear Chair Wagner and Ranking Member Sherman:

The National Association of Manufacturers—the largest manufacturing trade association in the United States, representing small and large manufacturers in every industrial sector and in all 50 states—appreciates the opportunity to provide this statement in advance of the Subcommittee's June 25 hearing on "Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets."

The NAM is the voice of the manufacturing community and the leading advocate for a policy agenda that supports and empowers the 13 million people who make things in America. As the largest manufacturing association in the United States, the NAM's membership includes businesses of all sizes, across all industrial sectors, and in all 50 states. Manufacturers collectively contribute $2.94 trillion to the U.S. economy—and right-sized, commonsense regulations are critical to sustaining the manufacturing strength that underpins our nation's prosperity.

The NAM applauds the Subcommittee for holding a hearing on Sarbanes-Oxley ("SOX"), as many small and medium-sized manufacturers incur substantial costs each year to comply with the law, and particularly Section 404(b). Striking the balance between capital formation and investor protection is a key test for any requirement that falls on smaller public companies. Capital spent on compliance burdens is diverted from R&D, new equipment, job creation, and worker benefits; absent a corresponding investor benefit, these funds are not being well used to grow the company and increase investor returns.

Sarbanes-Oxley, enacted in the wake of the accounting scandals of the early 2000s, provides for investor protection via requirements that public companies adopt a set of internal financial controls designed to reduce the likelihood of fraud and malfeasance. The law included three provisions intended to ensure the effectiveness of a company's internal controls over financial reporting ("ICFR"): 1.) Section 302, which requires management to evaluate and disclose its conclusion about the effectiveness of the company's controls and procedures in each quarterly and annual report; 2.) Section 404(a), which requires management to test the effectiveness of the company's internal control structure and procedures and to disclose its assessment in each

annual report; and 3.) Section 404(b), which requires companies to hire an outside auditor to publicly attest to management's assessment of the effectiveness of the company's ICFR.

Manufacturers strongly support the requirements in SOX Sections 302 and 404(a) that all public companies establish and maintain effective ICFR, which must be assessed for effectiveness by management each year. However, manufacturers have significant concerns about the costs of complying with SOX Section 404(b), a largely duplicative provision that has become a substantial cost burden for many publicly traded manufacturers. For a smaller manufacturer with a few dozen employees and one or two product lines—even if those product lines generate significant revenue—investors are unlikely to see a substantial benefit from the attestation audit required by Section 404(b), given the significant costs the audit imposes on the business.

I. Congress and the SEC Have Long Recognized the Need to Exempt Smaller Companies From SOX 404(b) Burdens

For more than two decades, Congress has recognized the significant cost burdens resulting from SOX 404(b) by providing exemptions from the attestation requirement for certain small companies that would pose limited risk to investors. For example, the Dodd-Frank Act created a permanent exemption for "non-accelerated filers" (at the time, defined as companies with public float below $75 million), while the JOBS Act of 2012 exempted "emerging growth companies" ("EGCs") (i.e., newly public companies with less than $1 billion in annual revenue in their first five years post-IPO).

While the Securities and Exchange Commission's record of easing burdens on smaller companies has been mixed, the Commission under Chairman Jay Clayton did finalize two rulemakings to provide relief. In 2018, the Commission updated its definition of "smaller reporting companies" ("SRCs")[1] by raising the maximum public float[2] threshold from $75 million to $250 million. This provided regulatory relief to more small businesses, but did not change the application of SOX 404(b), as the rule did not amend the non-accelerated filer definition. In 2020, the SEC approved a separate rulemaking[3] that classified low-revenue SRCs (i.e., those that reported less than $100 million in annual revenues during the most recent fiscal year) as non-accelerated filers, thus exempting them from the SOX 404(b) requirements. In a press release, the SEC explained that the 2020 amendments would "more appropriately tailor the types of issuers that are included in the definitions, thereby reducing unnecessary burdens and

[1] The SEC's "smaller reporting company" category, which benefits from reduced disclosure requirements, includes "non-accelerated filers," but not all SRCs are non-accelerated filers. The overlapping nature of these categories has caused confusion for smaller companies. As Commissioner Hester Peirce has observed, "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." Hester M. Peirce, Statement at Open Meeting on Proposed Amendments to Sarbanes Oxley 404(b) Accelerated Filer Definition (9 May 2019), *available at* https://www.sec.gov/newsroom/speeches-statements/peirce-proposed-amendments-sox-404b-accelerated-filer-definition.

[2] The SEC defines "public float" as a company's aggregate worldwide market value of common equity held by non-affiliates as of the last business day of the company's second quarter.

[3] SEC, Final Rule: Accelerated Filer and Large Accelerated Filer Definitions, 17 CFR Parts 229, 230, 240, and 249 (12 March 2020), *available at* https://www.sec.gov/files/rules/final/2020/34-88365.pdf.

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."[4]

While the proposed 2020 amendments were being considered by the SEC, opponents of reform argued that exempting additional smaller companies would decrease the quality of ICFR and increase the frequency of restatements. However, those warnings so far have proven unfounded. In a 2024 paper that examined the impact of the 2020 amendments, University of Georgia Accounting Professor Jennifer McCallen and her colleagues concluded:

> We find that exempted issuers rarely obtain an ICFR audit voluntarily, suggesting that affected issuers do not perceive an ICFR audit to be cost-beneficial. Using a difference-in-differences research design, we find no evidence that issuers under the revenue threshold experienced a decline in ICFR quality (i.e., increased material weaknesses) or financial reporting quality (i.e., increased misstatements, abnormal accruals) compared to issuers just over the threshold. Our analyses suggest that the expanded exemption was welcomed by most issuers and that the amendment did not significantly impair financial reporting quality.[5]

While the NAM supported the 2020 rulemaking, manufacturers believe that more should be done to reduce the Sarbanes-Oxley compliance costs borne by smaller companies. Under the SEC's current definitions, small companies are still subject to the specter of hefty SOX 404(b) compliance costs if their revenues continue to grow. A small but growing SRC with more than $75 million in public float will lose its non-accelerated filer status (and thus its SOX 404(b) exemption) if its annual revenue surpasses $100 million. In addition, some small companies have opted for debt financing rather than offer additional equity to investors so they can remain below the SEC's SRC public float threshold for SOX 404(b) compliance.[6] Notwithstanding the benefits that SOX 404(b) may bring to ICFR, they do not outweigh these disincentives for revenue growth and capital formation.

II. SOX Compliance Costs Remain Substantial, Especially for Smaller Companies

While larger companies typically pay more for SOX compliance, the relative burdens are not proportional, as even the smallest company subject to SOX 404(b) has to bear the substantial cost of hiring an outside audit firm for the ICFR attestation. Although a survey of audit firms

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[4] SEC, Press Release, "SEC Adopts Amendments to Reduce Unnecessary Burdens on Smaller Issuers by More Appropriately Tailoring the Accelerated and Large Accelerated Filer Definitions" (12 March 2020), *available at* https://www.sec.gov/newsroom/press-releases/2020-58.

[5] Jennifer McCallen, Roy Schmardebeck, Jonathan E. Shipman, and Robert Lowell Whited, "Financial Reporting Consequences of Exempting Low-Revenue Issuers from the Internal Control Audit Requirement" (1 November 2024), *available at* SSRN: https://ssrn.com/abstract=3420787.

[6] CFO.com, "SOX 404 Exemption Pushes Small Companies to Incur Debt: Study" (14 April 2020), *available at* https://www.cfo.com/news/sox-404-exemption-pushes-small-companies-to-incur-debt-study/656706/.

predicted[7] after the Sarbanes-Oxley Act took effect that compliance costs would eventually decrease as companies implemented their ICFR processes, public companies continue to pay significant audit fees and devote substantial staff time to SOX compliance two decades later.

The SEC's 2020 rulemaking estimated that a low-revenue SRC would save $210,000 a year if it was exempted from SOX 404(b), a figure that included a $110,000 reduction in audit fees and a $100,000 reduction in non-audit costs.[8] While the SEC eventually opted not to classify all SRCs as non-accelerated filers, the Commission evaluated that alternative and examined the audit fees paid by SRCs. The SEC concluded that 220 non-EGC companies would have become newly exempt from SOX 404(b) under that alternative and estimated that these companies would have saved an average of $415,000 per year in audit fees.[9]

However, more recent surveys of public companies indicate that most spend far more on their overall SOX compliance programs. In a 2022 survey report by consulting firm Protiviti, 30% of respondents (who all were from companies past their second year of SOX compliance) said they spent more than $2 million a year on compliance, up 24% from the year before.[10] KPMG, in a 2023 report based on a survey of 153 company respondents, estimated that the average company budget for SOX compliance was $1.6 million. For smaller companies (which KPMG defined as having less than $10 billion in annual revenue), the average SOX program budget was $1.1 million, a meaningful expense for companies of that size.

Likewise, NAM members report that they devote significant sums and staff hours to comply with Sarbanes-Oxley requirements. Here a few examples from the NAM's public company members:

- A mid-cap logistics company based in Pennsylvania reported that it spends $4.5 million per year on ICFR testing, which includes internal and external audit costs.
- A mid-cap engineering/manufacturing company based in Georgia reported that it spent $3.7 million on SOX compliance costs in fiscal 2024.
- A large-cap industrial company in New England spent about $3 million (which included 15,000 staff hours and $1.5 million in external audit fees) on SOX 404(b) compliance in 2024.
- A CFO at a NAM member company estimates that small- and mid-cap public companies spend about $1.5 million in initial costs to implement SOX 404(b) and then face ongoing costs of $500,000 to $1 million each year.

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[7] *See* Charles River Associates, "Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies" (April 2005), *available at* SARBANES-OXLEY SECTION 404 COSTS AND REMEDIATION OF DEFICIENCIES.

[8] Final Rule: Accelerated Filer and Large Accelerated Filer Definitions, *supra* note 3.

[9] Ibid. at 183.

[10] *See* Protiviti, "SOX Compliance Amid Rising Costs, Labor Shortages and Other Post-Pandemic Challenges" (2022). This report was based on a survey of more than 560 audit, compliance, and finance professionals in March and April of 2022.

As these estimates and survey responses illustrate, the annual costs of SOX 404(b) compliance far exceed the SEC's estimates and remain a substantial burden for public companies. More than 20 years after Section 404(b) took effect, it is time for Congress to step in again and expand the number of smaller companies that are spared from this duplicative and costly requirement.

III. Recommendations for Legislative Action

To remove the disincentives for growth and capital formation resulting from SOX 404(b), manufacturers encourage Congress to consider legislation that would exempt all SRCs from this costly compliance burden, regardless of their annual revenue.[11] Small public manufacturers should not have to forego revenue opportunities out of concern that they will unexpectedly cross the $100 million compliance threshold and trigger SOX 404(b) costs.

We also recommend that the Congress go further and exempt all accelerated filers, a category that now consists of small-cap companies, from SOX 404(b). When this category[12] of filers was created in 2005, it included many mid-cap companies, but the $700 million public float cap for this category has not been updated to reflect inflation and the growth in market valuation. As a result, many small- and mid-cap companies have graduated into large accelerated filer status, subjecting them to a regulatory regime designed for far larger businesses.[13] In our view, it does not make sense to subject a small-cap manufacturer with $75 million in public float (that has just enough revenue to become an accelerated filer) to same Sarbanes-Oxley requirements as a mega-cap company with more than $75 *billion* in public float. Such a disparity in relative compliance burdens is a real disincentive for these accelerated filers (and smaller companies that may grow into that category) to remain public.

Manufacturers also support a broader exemption for newly public companies, given the reality that Sarbanes-Oxley compliance costs remain among of the primary deterrents for companies that are considering going public. The NAM strongly supports Rep. Bryan Steil's bill, H.R. 3323,

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[11] As the SEC observed in 2020 when it evaluated the benefits of exempting all SRCs from SOX 404(b), "Reducing these additional issuers' costs would reduce their overhead expenses and may enhance their ability to compete with larger issuers. To the extent that the cost savings for the additional affected issuers enable capital investments that would not otherwise be made, this alternative would also lead to additional benefits in capital formation." Final Rule, Accelerated Filer and Large Accelerated Filer Definitions, *supra* note 3.

[12] The SEC's public float range ($75 million to $700 million) for accelerated filers is out of line with the current definitions of "mid-cap" companies. *See, e.g.,* Investopedia, "Mid-Cap: Definition, Other Sizes, Valuation Limits, and Example," *available at* https://www.investopedia.com/terms/m/midcapstock.asp (defined "mid-cap" to include companies between $2 billion and $10 billion in market cap); Nasdaq Glossary, *available at* https://www.nasdaq.com/glossary/m/mid-cap ("A stock with a capitalization usually between $1 billion and $5 billion."); *Forbes*, "What Are Mid-Cap Stocks? – Forbes Advisor" (13 November 2024) ("Mid-cap stocks are shares of companies with total market capitalization in the range of about $2 billion to $10 billion.").

[13] As SEC Commissioner Mark Uyeda has observed, accelerated filers, which accounted for 23% of reporting companies in 2005, have dwindled to 7%, while the percentage of companies that are deemed large accelerated filers has doubled from 18% to 36%. Mark T. Uyeda, "Remarks at the Florida Bar's 41st Annual Federal Securities Institute and M&A Conference" (24 February 2025), *available at* https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-florida-bar-022425.

the Helping Startups Continue to Grow Act, which would increase the revenue cap for emerging growth companies from $1 billion to $3 billion and extend the duration of the "IPO On-Ramp" for these startups from 5 years to 10 years.

Additionally, manufacturers believe that EGCs should not lose their EGC status (and their exemption from SOX 404(b)) if their public float grows to surpass $700 million, the current minimum threshold for large accelerated filers. This unfortunate consequence undercuts the important goals of the JOBS Act (and Rep. Steil's legislation) to promote more public offerings and capital formation. We encourage Congress to provide relief for these newly public companies as they seek to expand and raise more capital from the public markets (e.g., by increasing the minimum public float for the large accelerated filer category and/or by providing that EGCs do not lose their SOX 404(b) exemption if they cross the $700 million public float threshold).

Finally, we support the following reforms included in the Subcommittee's discussion draft legislation to modernize the SEC's definition of SRCs, including: 1) increasing the maximum public float threshold for SRCs from $250 million to $500 million; 2) increasing the maximum revenue threshold from $100 million to $250 million; 3) replacing the SRC definition's references to annual revenue with a three-year rolling average; and 4) clarifying that all SRCs should be excluded from the definitions of accelerated and large-accelerated filers (and thus exempt from SOX 404(b)).[14] Manufacturers are hopeful that Congress will enact these reforms and provide much-needed relief for all small companies from the costs and burdens associated with SOX 404(b).

* * * *

The NAM thanks the Subcommittee for holding this hearing, and manufacturers look forward to working with you to reduce Sarbanes-Oxley compliance costs for smaller companies.

Sincerely,

Charles Crain
Managing Vice President, Policy

[14] The NAM also favors increasing the minimum threshold for large accelerated filers, but we would recommend consideration of a significantly higher minimum threshold (such as $5 billion in public float) so that category, which has the strictest compliance burdens, would no longer include small-cap and smaller mid-cap issuers.

american securities association
America's Voice for Main Street's Investors

June 25, 2025

The Honorable Ann Wagner
Chairman
Capital Markets Subcommittee
U.S. House of Representatives
Washington, DC 20515

The Honorable Brad Sherman
Ranking Member
Capital Markets Subcommittee
U.S. House of Representatives
Washington, DC 20515

Re: June 25th Hearing Entitled "Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets"

Dear Chair Wagner and Ranking Member Sherman:

The American Securities Association (ASA)[1] submits these comments for the scheduled June 25th hearing of the Capital Markets Subcommittee to examine the ongoing consequences for America's capital markets stemming from the 2002 Sarbanes-Oxley Act. (Sarbanes-Oxley)

Background Information

Sarbanes-Oxley was a hurried attempt by Congress to address internal control and auditing failures that contributed to the Enron and WorldCom accounting scandals almost twenty-five years ago. Although there was wide agreement among Congress at the time that a national response to those scandals was necessary, little consideration was given to the costs that Sarbanes-Oxley would impose on America's public companies – especially younger, smaller companies that wanted to enter the public markets.

After more than two decades, we now have a full understanding of the magnitude of those costs. Perhaps no other law or regulatory action in history has done more to disincentivize initial public offerings (IPOs) and weaken the competitiveness of the U.S. capital markets than Sarbanes-Oxley. The collapse of the IPO market in the mid-late 2000's is directly attributable to several of the dictates in Sarbanes-Oxley.

Thankfully, it took Congress less than a decade to realize the mistakes it made with Sarbanes-Oxley. In 2011, the Obama Administration convened the Access to Capital Conference to examine the causes behind the IPO decline and hear recommendations to boost U.S. market competitiveness. An outgrowth of this conference was the IPO Task Force, a group of market

[1] ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This mission advances financial independence, stimulates job creation, and increases prosperity. ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.

practitioners that produced an influential report containing several recommendations for policymakers.[2]

Central to the IPO Task Force's report were the costs related to Sarbanes-Oxley Section 404 which requires management to maintain internal controls over financial reporting (ICFR) and demands an outside auditor examine and attest to those controls. While Section 404 received little attention when Congress was considering Sarbanes-Oxley, it ultimately became the most consequential and costly compliance burden in the law. When the Securities and Exchange Commission (SEC) adopted final rules to implement Section 404, it was forced to acknowledge the rules would "discourage some companies from seeking capital in the public markets."[3]

This compelled Congress to pass the Jumpstart Our Business Startups (JOBS) Act in 2012. Title I of the JOBS Act established the emerging growth company (EGC) as a new class of SEC registrant, and exempted EGCs from the auditor attestation requirements of Sarbanes-Oxley. The benefits of the JOBS Act became apparent immediately as it reinvigorated a dormant IPO market in the years immediately following law's enactment.

Sarbanes-Oxley also created the Public Company Accounting Oversight Board (PCAOB), an ostensibly 'independent' board charged with overseeing and setting standards for the auditing industry. Over time, however, the PCAOB has ignored the costs that its standards impose and has been heavily influenced by politicized special interest groups pushing a radical agenda.

This was evident in recent years when the PCAOB spent its resources on advancing proposals were far outside its remit, including the Noncompliance with Laws and Regulations (NOCLAR) initiative. The ASA supports legislation advanced by this Committee that would migrate the responsibilities of the PCAOB to the SEC and bring greater transparency and accountability towards regulation of the audit industry.

The PCAOB also completely failed to protect American investors from fraudulent Chinese companies. Its intentional disregard and deliberate failure in enforcing Chinese companies' compliance with basic financial reporting standards became so egregious Congress had to pass another law to force the PCAOB to do its job.[4]

Moving Forward

The ASA continues to support bills that would address the costs of Sarbanes-Oxley for small public companies. These include the Helping Startups Continue to Grow Act which would extend the JOBS Act IPO "on-ramp" and legislation that would amend the large, accelerated filer

[2] https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf
[3] Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports. 68 Fed. Reg. 36636 (June 2003)
[4] https://www.kennedy.senate.gov/public/2022/12/kennedy-legislation-to-further-protect-americans-from-fraudulent-chinese-companies-becomes-law

and smaller reporting company (SRC) definition to exempt certain businesses from Section 404 mandates. We also believe this committee should revisit the obstruction of justice charges set forth in the act to make certain they cannot be used for unintended and political purposes by overzealous bureaucrats. We are encouraged that the Financial Services Committee has prioritized examining Sarbanes-Oxley and put forth these bills, and we are hopeful that Congress can pass them and other ideas that may come out of the hearing before the end of this Congress.

Conclusion

We appreciate the Committee's attention to these critical matters and look forward to working with all members to address the lingering effects of Sarbanes-Oxley and boost capital formation throughout the U.S. economy.

Sincerely,

Christopher A. Iacovella

Christopher A. Iacovella
President & Chief Executive Officer
American Securities Association

SOCIETY
for Corporate Governance

June 20, 2025

The Honorable Paul Atkins
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Submitted electronically

Re: Suggestions on Modifying and Scaling the Disclosure Obligations of Small- and Mid-Cap Public Companies

Dear Chairman Atkins:

On behalf of the Society for Corporate Governance (the "Society"), as previewed in our letter to you, dated May 1, 2025,[1] I am writing to provide our input on the Commission's filer categories and certain disclosure obligation-related modifications and simplifications that would benefit small- and mid-cap public companies (as well as, in certain circumstances, other issuers) and their stockholders.

By way of background, the Society is a professional membership association of more than 3,700 corporate and assistant secretaries, chief legal officers and other in-house counsel, outside counsel, and other governance professionals who serve and/or represent public and private companies of almost every size and industry, including small and mid-cap companies. Society members are responsible for supporting the work of corporate boards and management in the areas of governance, securities laws, SEC reporting and compliance. The suggestions included below are also informed by issuers who are members of the Society's Small- and Mid-Cap Companies Committee.

As then-Acting Chairman Uyeda noted at the Florida Bar's 41st Annual Federal Securities Institute and M&A conference, it is time "to re-align the Commission's filer categories to reflect the size and makeup of public companies today" and, in connection with that process, to "identify rules that should apply only to the largest companies."[2] While not intended to be comprehensive, our suggestions for action the Commission could take to address these topics appear below and are also presented in greater detail in the attached Appendix.

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[1] *See* Society for Corporate Governance, *Letter to The Honorable Paul Atkins* (dated May 1, 2025), *available at* https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/5d47927b-105a-4bc7-9aef-821536f3505b/UploadedImages/Society_for_Corporate_Governance_Letter_to_SEC_Chairman_Atkins_.pdf.

[2] *See* Commissioner Mark T. Uyeda, "Remarks at the Florida Bar's 41st Annual Federal Securities Institute and M&A Conference" (Feb. 24, 2025) ("Uyeda February 2025 Speech") (noting that "[o]utdated financial thresholds, lack of scaling, and overlapping definitions can result in a complex and ineffective regulatory regime, imposing unnecessary costs on companies and their shareholders"); *available at* https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-florida-bar-022425.

We note that these suggestions are generally targeted towards small- and mid-cap companies; however, we believe that some of these suggestions, as identified in the attached Appendix, could also be used to simplify disclosure requirements more broadly, with an aim of identifying requirements that impose costs outweighing their benefits, irrespective of company size. We appreciate the Commission's consideration of our views, which we believe are consistent with the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, and look forward to being able to further discuss them with the Commission's Staff and have our issuer members share their current experience with respect to the matters below.

I. *Filer Status and Thresholds*

The current structure of overlapping filer statuses is complicated and burdensome for registrants, particularly small- and mid-cap companies. The Commission has not changed its thresholds for a company to qualify as a large accelerated filer or accelerated filer since they were established in 2005.[3] In addition, following the introduction of the smaller reporting company ("SRC") and emerging growth company ("EGC") categories in 2008 and 2012, respectively, small- and mid-cap companies have been faced with a complicated mix whereby a registrant may fit into multiple categories, each with different requirements and accommodations. Registrants spend significant time and expense trying to determine which filer status they fit into and what the associated requirements, including transition thresholds and periods, may be. For example, Luna Bloom, Acting Associate Director (Legal and Regulatory Policy) in the Division of Corporate Finance, noted during "The SEC Speaks" Conference in May 2025,[4] that SRCs, which comprise almost 50% of registrants, may be non-accelerated filers or accelerated filers, and/or may also be EGCs or not EGCs, and depending on the combination of those statuses, the disclosure requirements and accommodations available to that company will change. Similarly, as then-Acting Commissioner Uyeda noted earlier in the year that "[t]his distinction has real-world cost implications as[, for instance,] non-accelerated filers do not need to provide an auditor attestation of the company's evaluation of its internal control over financial reporting."[5] And, as Commissioner Peirce remarked in 2019, the process for determining whether a company is an SRC and/or accelerated filer is "so complicated that even [Commission staff] need diagrams to figure it out."[6] The Society's Small- and Mid-Cap Companies Committee echoes these concerns: these overlapping statuses and requirements cause confusion, create substantial compliance burdens, and add significant compliance costs for small- and mid-cap registrants, even though as, recognized by Commissioner Uyeda, "not all seasoned companies are equal in terms of legal and financial reporting personnel, budgets for outside counsel, auditors, and advisors, and board and management time to devote to the Commission's ever-growing disclosure requirements."[7]

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[3] *See* Uyeda February 2025 Speech, *supra* note 2.

[4] *See* "The SEC Speaks" Conference, Division of Corporate Finance (May 19, 2025) *available at*: https://www.pli.edu/programs/the-sec-speaks/413804.

[5] *See* Uyeda February 2025 Speech, *supra* note 2.

[6] *See* Commissioner Hester M. Peirce, "Statement at Open Meeting on Proposed Amendments to Sarbanes Oxley 404(b) Accelerated Filer Definition" (May 9, 2019), *available at:* https://www.sec.gov/newsroom/speeches-statements/peirce-proposed-amendments-sox-404b-accelerated-filer-definition.

[7] *See* Commissioner Mark T. Uyeda, "Remarks at the Practising Law Institute's 55th Annual Institute on Securities Regulation" (Nov. 7, 2023) ("Uyeda November 2023 Speech"), *available at*: https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-practicing-law-institute-110723.

Therefore, the thresholds for SRCs and filer statuses should be aligned and updated, based on a combination of public float and annual revenue (which is based on the EGC annual revenue threshold),[8] as shown in the Appendix, which would result in two categories of filer status:

- Registrants with a public float of less than $2 billion *or* annual revenues below $1.235 billion would qualify as both an SRC[9] and non-accelerated filer (thereby aligning the two categories).

- Registrants with a public float of $2 billion or more *and* annual revenues of $1.235 billion or more would be large accelerated filers (and, therefore, will lose SRC status).[10]

Our proposal for simplifying and easing burdens on public companies with only two categories has the additional advantage of alignment with the EGC definition. We believe aligning the annual revenue threshold for SRC and non-accelerated filer status with the EGC annual revenue threshold will significantly simplify compliance and transition testing that registrants currently have to undergo (often at different times in a year) and may further encourage issuers that are eligible for EGC exemptions to enter public markets. EGC status is defined in Section 2(a)(19) of the Securities Act of 1933, as amended, and in Section 3(a)(80) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Our proposal for the annual revenue threshold is the same as the current $1.235 billion threshold for EGC status, and if adopted for SRC and filing status, we would encourage the Commission to provide that such revenue number will be subject to adjustment for inflation every five years, to remain consistent with the EGC annual revenue number.[11]

Adding a revenue measurement that aligns with EGC status across all filer categories in addition to public float is helpful because it is not as susceptible to industry or economic trends that are not specific to any particular issuer, and could be a "more predictable… indicator of an issuer's complexity, and a better indicator of an issuer's ability to absorb the burdens of" compliance.[12] And, of course, simplifying the

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[8] An EGC means an issuer that had total annual gross revenues of less than $1.235 billion during its most recently completed fiscal year. To remain an EGC, the company must have been public for not more than five fiscal years, must not have issued over $1 billion in non-convertible debt over the previous three-year period, must not have exceeded $1.235 billion in annual gross revenues and must not have become a "large accelerated filer," as defined in Rule 12b-2. *See* 17 CFR 240.12b-2. The revenue threshold is required to be indexed for inflation every five years. *See* Section 2(a)(19)(A) of the Securities Act of 1933, as amended.

[9] Currently, a company qualifies as a smaller reporting company if its public float is less than $250 million. A company can also qualify if it generated less than $100 million in annual revenues and had a public float of less than $700 million. *See* 17 CFR 240.12b-2.

[10] Assuming a total of 7,243 reporting issuers who filed a Form 10-K in 2023, and using a Bloomberg terminal list of publicly listed companies on U.S. stock exchanges and their market capitalization as of June 6, 2025, and their trailing 12-month revenue, we estimate that our proposed thresholds would subject approximately 17% of registrants to large accelerated filer status. *See* Vladimir Ivanov, Michael Pessin, and Albert Sheen, "Counts of Reporting Issuers Subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 and Public Firms in 2023" (April 2025), *available at*: https://www.sec.gov/files/dera-registrant-count-2504.pdf. We recognize that "market capitalization" does not perfectly align with "public float" of public companies and, in practice, would expect the group to be slightly larger than 17% given that public float typically trails market capitalization. *See* also footnote 13 for additional details.

[11] We would also encourage the Commission to consider whether the public float threshold should be regularly adjusted for inflation, consistent with the approach for the EGC annual revenue threshold.

[12] *See* Accelerated Filer and Large Accelerated Filer Definitions, Release No. 34-88365, File No. S7-06-19 (Mar. 12, 2020) ("2020 Filer Category Adopting Release") at p. 12; *available at*: https://www.sec.gov/files/rules/final/2020/34-88365.pdf. In addition, in the 2020 Filer Category Adopting Release, the Commission acknowledged that they "continue to believe that revenue is an appropriate measure for determining whether an issuer should be considered a

(Cont'd on next page)

complex regime of various filer statuses and exemptions is just as critically important as making sure that the right exemptions are available to smaller registrants, while maintaining appropriate investor protections.[13]

The Appendix also includes our proposed framework for simplifying transition periods and thresholds, whereby registrants would test their status at each December 31 to determine whether they reach (or no longer reach) the applicable thresholds. In the event that a registrant reaches the large accelerated filer thresholds at such December 31 testing, they would become a large accelerated filer as of December 31 of the following year and would be required to comply with such requirements for their Form 10-K in that subsequent year. However, if upon testing at the following December 31 (i.e., the "anticipated compliance start date"), a registrant no longer meets the large accelerated filer thresholds, they will remain an SRC and non-accelerated filer and continue to test at each December 31.[14] We believe this revised testing

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non-accelerated filer." While the revenue thresholds adopted at the time are different from what is being proposed here, we agree that it is important to take revenues into account when realigning the current reporting filer thresholds. *Id.* at p. 29. The SRC/non-accelerated filer category would also include any company that has not been a reporting company for one year and that has not filed a Form 10-K, which is consistent with the current definition of non-accelerated filer.

[13] When preparing this proposal, we gave serious consideration to Commissioner Uyeda's 2023 remarks at the Practicing Law Institute suggesting that a triangle model would be one option for scaled disclosure requirements (noting that "[f]or instance, the Commission should consider applying scaled disclosure using the model of a triangle" and questioning whether dividing the companies between small and large companies is too simplistic). Commissioner Uyeda noted that at the time when the current thresholds for large accelerated filers were established in 2005, approximately 18% of reporting companies had a public float of at least $700 million (the threshold for large accelerated filer status), but that, as of 2023, the top 18th percentile for reporting companies' public float was approximately $3.2 billion. *See* Uyeda November 2023 Speech, *supra* note 7. However, our concern with using only the public float thresholds, and, thereby, retaining the "accelerated filer" status, is that many public companies with a significant public float, in fact, have zero or very little revenues (this could happen, for instance, due to investors' belief in potential for future growth, as is often the case at early stage biopharmaceutical companies). For example, using a Bloomberg terminal list of publicly listed companies on U.S. stock exchanges as of June 6, 2025, we estimate that there are at least 11 companies with a market capitalization above $3.2 billion with no revenues for the last 12 months. These companies typically do not have the money or resources to spend on high compliance cost disclosures as they are rightfully focused on generating revenues. In addition, in an effort to encourage simplification, the proposed revenue threshold is meant to provide continuity for EGCs if that status expires (see footnote 8 above) on the basis of time only or due to issuing more than $1 billion in non-convertible debt (and the registrant has not yet exceeded the revenue threshold) and eliminate the often-confusing SRC accelerated filer vs. non-accelerated filer testing. As Commissioner Uyeda noted, "[c]urrently, only one requirement differentiates large accelerated filers – the 60-day deadline for filing Form 10-K" from accelerated filers. *See id.* (citing General Instruction A(2)(a) of Form 10-K). Therefore, the "accelerated filer" status only complicates the analysis without currently providing any real substantive benefits to issuers (and, if thresholds are adjusted, those "accelerated filer" issuers would continue to benefit from the SRC/non-accelerated filer status and associated exemptions). Importantly, from an investor protection perspective, although an SRC/non-accelerated filer will not be subject to the internal control over financial reporting ("ICFR") auditor attestation requirement, "it will remain subject to the [Section 404(a) of the Sarbanes-Oxley Act] requirement to state in its annual report the responsibility of management for establishing and maintaining an adequate control structure and procedures for financial reporting, and for that report to contain an assessment of the effectiveness of that structure and its procedures" will continue to be required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in conformity with [generally accepted accounting principles]," and will "remain subject to a financial statement audit by an independent auditor," each of which help maintain appropriate investor protection. *See* 2020 Filer Category Adopting Release at p. 32-33.

[14] The same transition periods/testing will apply to falling out of the Large Accelerated Filer status. In addition, the Commission could consider providing for a two-year transition period in order to avoid situations where the registrant has to expend compliance costs in year 1 just to fall out of compliance in year 2.

and transition framework will ease the process for registrants to determine which filing categories they fall into, allowing time to prepare for new enhanced disclosure requirements, and will also ensure that a company's results for one year were not anomalous, establishing that the company should truly transition into the large accelerated filer category.[15]

II. *Scaled Reporting Requirements*

In addition to re-aligning the filer categories, there should be more done to scale disclosure requirements across filing categories, which we believe would encourage companies to become and stay public, particularly small- and mid-cap registrants. As Commissioner Peirce noted in her remarks before the Northwest Securities Institute[16] last month, the number of initial public offerings ("IPOs") has been decreasing in recent years – with just 72 IPOs in 2024 compared to 134 in 2018. Commissioner Peirce remarked that scaled public disclosure requirements for EGCs and SRCs would "allow new and growing companies to ease into the full panoply of public company reporting requirements."[17] The Office of the Advocate for Small Business Capital Formation also recommended in its 2024 Annual Report that the Commission consider scaling obligations and phasing in compliance for smaller public companies to better balance the costs and benefits of being a small public company.[18] We have identified the following rules and regulations as opportunities for the Commission to simplify and/or scale disclosure requirements for small- and mid-cap registrants. While this is largely focused on small- and mid-cap registrants, we also believe that, in certain circumstances, other registrants can also benefit from certain changes and have clearly indicated such instances with an asterisk in the Appendix for the Commission's consideration. Finally, we believe these changes can be effectuated relatively quickly and regardless of whether—or when—the Commission proceeds with any amendments set forth in Part I of this letter, particularly when it comes to aligning the existing disconnect between the EGC and SRC exemptions.

We propose to maintain the current exemptions for EGCs, SRCs and non-accelerated filers, and in addition, make changes to align the exemption for these two categories as follows:

- *Form 10-K/10-Q-Related Simplifications:* We respectfully request that the Commission:
    - remove the requirement that SRCs' audit reports include disclosure regarding critical accounting matters that an auditor identifies during the course of the audit, consistent with the treatment for EGCs.

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[15] Currently, registrants are subject to the following transition thresholds: falling below $60 million in public float for exiting large accelerated or accelerated filer status and becoming a non-accelerated filer, and falling below $560 million (but above $60 million) of public float for exiting large accelerated filer status and becoming an accelerated filer, as well as certain revenue transition thresholds for qualifying or requalifying as a smaller reporting company (of $100 million or $80 million, as applicable). *See* 17 CFR 240.12b-2. These differing transition thresholds from the thresholds included in the SRC, accelerated filer and large accelerated filer definitions further complicate the testing that registrants have to undergo to assess compliance and their status. Our proposed framework seeks to eliminate differing thresholds. Notably, our proposed thresholds would not change the financial thresholds for well-known seasoned issuers ("WKSIs") because we believe that the WKSI status should be about reliability of disclosures more than about the size of the public float.

[16] *See* Commissioner Hester M. Peirce, "Bridging the Gap: Remarks before the Northwest Securities Institute" (May 30, 2025) ("Peirce May 2025 Speech"), *available at*: https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-northwest-securities-institute-053025.

[17] *See* Peirce May 2025 Speech, *supra* note 16.

[18] *See* Office of the Advocate for Small Business Capital Formation, "Fiscal Year 2024 Annual Report," *available at*: https://www.sec.gov/files/2024-oasb-annual-report.pdf.

- remove the requirement for all SRCs to provide an auditor attestation of internal control over financial reporting under Sarbanes-Oxley Act Section 404(b), which results from categorizing all SRCs as non-accelerated filers.
- revise Item 408(a) of Regulation S-K to exempt EGCs and SRCs from the requirement to provide quarterly disclosure regarding director and officer entrance into or termination of a Rule 10b5-1 trading arrangement or non-Rule 10b5-1 trading arrangement.
- revise the Rule 12b-25 deadlines and provide that, in the event of a filed Form 12b-25, an EGC or SRC may file their late Form 10-K or Form 10-Q within 30 days or 15 days, respectively, of the original due date (as opposed to 15 and five days, respectively).

- *Proxy- & Executive Compensation-Related Simplifications:* We respectfully request that the Commission:
  - to the extent wholesale exemptions are not provided on executive compensation disclosure requirements, align exemptions available to SRCs and EGCs and also provide for additional exemptions for such filers from certain executive compensation-related requirements.[19] This includes:
    - eliminating the requirement for SRCs to provide pay versus performance disclosure under Item 402(v) of Regulation S-K, consistent with the treatment for EGCs; and
    - eliminating the requirement for SRCs to provide the say on pay vote and say on frequency votes under Rule 14a-21, consistent with treatment for EGCs.
  - remove the requirement for XBRL tagging for proxy statements or, alternatively, provide that any failure to properly XBRL tag does not impact a registrant's Form S-3, Form S-8 or Rule 144 eligibility.
  - align the related person transaction reporting threshold and lookback period included in Item 404 of Regulation S-K for SRCs with the reporting threshold and lookback period for EGCs and non-SRC registrants, rather than having a different reporting threshold and longer lookback period for SRCs; in addition, we recommend considering raising the $120,000 threshold for all registrants.
  - revise Rule 14a-3 under the Exchange Act to provide that a registrant's Form 10-K satisfies the annual report requirements in Rule 14a-3(b) and to eliminate the requirement to re-file or furnish a separate Form ARS with the Commission, which annual report filing is currently useless and duplicative of companies' Form 10-K filing.

[19] We understand there is a separate roundtable being hosted to discuss executive compensation disclosure requirements and potential associated disclosure simplification initiatives. However, the Appendix includes certain executive compensation matters for the Commission's consideration, which we would be happy to discuss further. For instance, we believe that SRCs, like EGCs, should be exempt from a say-on-pay vote considering they are exempt from having to provide Compensation Discussion & Analysis under Item 402 of Regulation S-K. Similarly, we believe the rules should be revised to eliminate little "r" restatements as a trigger).

- *Section 16 and Rule 144 Reporting / Form 11-K Filings:*[20] We respectfully request that the Commission:
    - exempt any transaction that is not a voluntary open market acquisition or disposition (e.g., equity award vesting, net share settlement (at least for non-option awards) and non-exempt dividend reinvestments) from the two-business day Form 4 filing deadline. Any such non-volitional transactions would be reported on the next Form 4. Most transactions that are currently required to be reported on Form 4 within two business days are immaterial, non-volitional and offer little helpful information to investors.
    - eliminate the requirement to file Form 144s for affiliates of EGCs and SRCs, which are burdensome due to the very short filing deadline (same day).
    - exempt EGCs and SRCs from the requirement to file a Form 11-K for annual reports of employee stock purchase, savings and similar plans interests in which constitute securities registered under the Securities Act of 1933.

We believe the re-alignment of filer categories and simplification and scaling of disclosure obligations, particularly for small- and mid-cap public companies, will simplify the regulatory regime while reducing unnecessary costs on companies and their shareholders, thereby encouraging greater capital formation and facilitating well-functioning public markets.

Thank you for your consideration of the Society's views. The Society looks forward to having a meeting to elaborate on these suggestions.

Respectfully submitted,

Paul F. Washington
President and Chief Executive Officer
Society for Corporate Governance

cc:

Commissioner Hester Peirce
Commissioner Caroline Crenshaw
Commissioner Mark Uyeda

[20] Another area where we believe all issuers, but certainly SRCs, EGCs and non-accelerated filers, could benefit from is not having to file a Form SD relating to conflict minerals. While conflict mineral rules are part of Dodd-Frank Wall Street Reform and Consumer Protection Act, we believe an exemption can be granted by the Commission pursuant to the Commission's general exemptive authority under Section 36(a) of the Exchange Act.

Appendix

(see attached)

From Ranking Member Waters:

1. Which of the following options best describes your self-identified race? (You may choose more than one.)

White or Caucasian & Hispanic/Latinx

2. Which of the following options best describes your gender identity?

Woman

3. Your study relies on 2001-2007 data, when virtually all accelerated filers— including many early-stage companies—had to obtain a full Section 404(b) attestation under the AS-2 standard. Since then, PCAOB AS-5 has reduced audit scope, the JOBS Act now exempts Emerging Growth Companies, and the SEC's 2020 rule further exempts many small and medium filers from 404(b) entirely. Given those changes, what evidence do you have—or would you need—to conclude that the R&D crowd-out you document still persists for young public firms that either receive streamlined 404(b) audits or no attestation at all?

Thank you for this important question.

Our testimony has highlighted a large volume of interdisciplinary research, including our own, which points to important costs and benefits that we believe are relevant to current policy conversations surrounding SOX. An important caveat is that the empirical evidence from most prior research (including ours) is necessarily limited to a now historical timeframe. A key question is to what extent the documented costs and benefits of SOX remain relevant for policymakers evaluating prevention versus remediation strategies today.

In our view, theoretical insights from well-designed academic research are more likely to generalize than the specific cost-benefit point estimates found in any single study. Specifically, our research highlights that:

- In addition to direct costs there are indirect costs associated with compliance that manifest because of changes to firm culture. These costs are asymmetric across firms.
- The benefits of regulation are also asymmetric across firms. Internal control provisions may be highly effective for some firms but ineffective for others.
- Regulatory exemptions that focus exclusively on firm size do not adequately capture these tradeoffs. Specifically, our research highlights the effects of firm life-cycle stage beyond the effects of firm size.

These points are consistent with the intent of the JOBS act, which acknowledges public firm tenure as an important moderating factor to costs, and the SEC's 2020 carve-out which exempts certain low revenue filers on the basis that the benefits of internal controls may be attenuated for these firms.

We have not replicated our analysis in the context of these subsequent regulatory adjustments. However, our rough calculations suggest that by our measure of life-cycle stage a substantial proportion of firms are still subject to 404(b) requirements even after considering these additional exemptions for EGC and adjusted accelerated filer definitions. That is, these exemptions are not fully congruous with the firm characteristics which we study.

Accordingly, it is an open empirical question whether these changes are sufficiently targeted to attenuate the costs to R&D and innovation documented by our research. We believe that subsequent research which re-examines this question with contemporary data (and ideally in collaboration with the more granular data available from the SEC and PCAOB to assess offsetting benefits) would be useful to regulatory conversations about the current net benefit calculus of SOX provisions.

Notwithstanding, we emphasize that in complex settings like the US capital markets, even with perfect data to evaluate the costs and benefits of regulatory adjustments, there are rarely perfect solutions—only tradeoffs. In considering such tradeoffs we do not propose a solution, rather we advise strategic deliberation that weighs the costs and benefits from a prevention versus remediation focused policy depending on the nature of the firm.

Additionally, we encourage policymakers to consider the following three factors that may nuance the applicability of research studying the implementation of SOX in the early 2000s (including ours) to the U.S. capital markets today:

1) The pace of technological change,
2) changes in composition and characteristics of public firms, and
3) the impact of deregulation versus introducing new regulation.

First, **technological advancements** – particularly in financial reporting – have significantly transformed corporate accounting systems. When functioning well, automated accounting systems can be an important part of a system of internal controls that prevent or detect misstatements before financial statements are issued as well as increase the efficiency of the reporting system. At the same time, widespread automation of processes may heighten the potential risk of systemic errors. In manual systems, internal control failures may affect only a limited number of transactions. In contrast, failures in automated systems can propagate across large volumes of data. More research is needed to understand how these changes will influence the risk of financial reporting errors and the effectiveness of financial regulation relative to time periods with less access to technology.

Second, **the composition and characteristics of publicly traded firms** has evolved since the early 2000s alongside the broader U.S. economy. While academic studies typically report average effects for a population, group averages may obscure important differences across firm types. Academic research is effective at quantifying average effects for a particular population, but these effects may manifest differentially for individual firms. Likewise, how different firms respond to incentives may shift in response to a changing economic environment. Accordingly, as the global competitive landscape and nature of firms continues to evolve historical average effects may no longer reflect current realities.

Third, **the costs associated with SOX implementation may not be fully reversible through deregulation**. For incumbent public firms, the initial costs of establishing internal control audits have largely been absorbed, leaving only ongoing maintenance costs as potentially recoverable through deregulation. Moreover, if SOX induced persistent changes to corporate compliance culture which are detrimental to risk taking and innovation, that culture may persist even if regulatory requirements are relaxed, thereby limiting the potential benefits of repeal. However, newly public firms exempted from full SOX compliance could avoid initial implementation costs and may benefit from a regulatory approach that appropriately balances prevention and remediation.

We appreciate the opportunity to submit testimony and hope our understanding can help to frame the subcommittee's decision analysis and facilitate informed debate on the tradeoffs inherent in capital markets regulation. We are happy to provide additional testimony if we can be helpful to you in the future.

LAWRENCE A. CUNNINGHAM

July 24, 2025

Svent Bossart, Clerk
House Financial Services Committee
United States House of Representatives
Washington, DC 29515

Dear Mr. Bossart,

Thank you for your email of earlier today, attaching the following two questions from Ranking Member Maxine Waters of the House Committee on Financial Services following up on my June 25 testimony on the topic of "Reassessing Sarbanes-Oxley."

1. Which of the following options best describes your self-identified race? (You may choose more than one.)

a. White or Caucasian
b. Black or African American
c. Hispanic/Latinx
d. Asian
e. Middle Eastern/North African
f. Choose not to answer
g. Prefer to self-describe (please specify)

2. Which of the following options best describes your gender identity?

a. Woman
b. Man
c. Non-binary
d. Transgender Man
e. Transgender Woman
f. Choose not to answer
g. Prefer to self-describe (please specify)

The questions ask flatly about my race and gender. I respectfully decline to answer these questions. In my view, they are not relevant to the substance of my testimony or my qualifications to provide it. Moreover, I believe such inquiries—particularly when directed to private citizens appearing voluntarily in a policy hearing—implicate serious concerns of privacy, propriety, and potentially constitutional limits.

Sincerely,

Lawrence A. Cunningham

30 July 2025

Representative French Hill
Chairman, Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington DC 20515

Dear Chairman Hill:

Pursuant to your letter of July 24th requesting I respond to Ranking Member Waters' Questions for the Record, I hereby submit the following responses:

1. Which of the following options best describes your self-identified race? (You may choose more than one.)

A and D, I identify as Caucasian and Asian

2. Which of the following options best describes your gender identity?

B, I identify as male

Thank you again for the opportunity to testify to the Subcommittee on Capital Markets.

Sincerely,

Frank Watanabe
President and CEO

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Suite 300
Westlake Village, CA 91361 USA

+1 805 418 5006
information@arcutis.com
Arcutis.com

John Coates

Response to Questions

From Ranking Member Waters:

1. Which of the following options best describes your self-identified race? (You may choose more than one.) a. White or Caucasian b. Black or African American c. Hispanic/Latinx d. Asian e. Middle Eastern/North African f. Choose not to answer g. Prefer to self-describe (please specify)

   White

2. Which of the following options best describes your gender identity? a. Woman b. Man c. Non-binary d. Transgender Man e. Transgender Woman f. Choose not to answer g. Prefer to self-describe (please specify)

   Man

[~118H2603]

[DISCUSSION DRAFT]

119TH CONGRESS
1ST SESSION

H. R. _____

To require the Securities and Exchange Commission to revise certain thresholds related to smaller reporting companies, accelerated filers, and large accelerated filers, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

M__. _____ introduced the following bill; which was referred to the Committee on _____

A BILL

To require the Securities and Exchange Commission to revise certain thresholds related to smaller reporting companies, accelerated filers, and large accelerated filers, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SMALLER REPORTING COMPANY, ACCELERATED FILER, AND LARGE ACCELERATED FILER THRESHOLDS.

(a) SMALLER REPORTING COMPANIES.—

(1) IN GENERAL.—The Securities and Exchange Commission shall revise the definition of a ''smaller reporting company'' under section 229.10(f)(1) of title 17, Code of Federal Regulations—

(A) in paragraph (i), by adjusting the public float threshold from $250,000,000 to $500,000,000; and

(B) in paragraph (ii)—

(i) by adjusting the annual revenue threshold from $100,000,000 to $250,000,000; and

(ii) in paragraph (B), by adjusting the public float threshold from $700,000,000 to $900,000,000.

(2) USE OF THREE-YEAR ROLLING AVERAGE REVENUES.—The Securities and Exchange Commission shall revise paragraphs (1)(ii) and (2)(iii)(B) under the definition of ''smaller reporting company'' under section 229.10(f)(1) of title 17, Code of Federal Regulations, by substituting ''three-year rolling average revenues'' for ''annual revenues''.

(3) CONFORMING CHANGES.—The Securities and Exchange Commission shall revise the definition of a ''smaller reporting company'' under sections

230.405 and 240.12b–2 of title 17, Code of Federal Regulations, and any other rule of the Commission in the same manner as such definition is revised under paragraphs (1) and (2).

(b) ACCELERATED FILERS AND LARGE ACCELERATED FILERS.—

(1) LARGE ACCELERATED FILER.—The Securities and Exchange Commission shall revise the definition of a "large accelerated filer" under section 240.12b–2(2) of title 17, Code of Federal Regulations, to increase the threshold amount (for the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of an issuer) from $700,000,000 to $750,000,000.

(2) THRESHOLD TO EXIT ACCELERATED FILER STATUS.—The Securities and Exchange Commission shall revise section 240.12b–2(3)(ii) of title 17, Code of Federal Regulations, to increase the threshold amount (for the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of an issuer) at which an issuer is no longer an accelerated filer from $60,000,000 to $75,000,000.

(3) THRESHOLD TO EXIT LARGE ACCELERATED FILER STATUS.—The Securities and Exchange Com-

mission shall revise section 240.12b–2(3)(iii) of title 17, Code of Federal Regulations, to increase the threshold amount (for the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of an issuer) at which an issuer is no longer a large accelerated filer from $560,000,000 to $750,000,000.

(4) EXCLUSION OF SMALLER REPORTING COMPANIES.—The Securities and Exchange Commission shall revise the definitions of an ''accelerated filer'' and a ''large accelerated filer'' under paragraphs (1) and (2) of section 240.12b–2 of title 17, Code of Federal Regulations, respectively, to exclude any issuer that is a smaller reporting company, as defined under section 229.10(f)(1) of title 17, Code of Federal Regulations.

[~118H2606]

[DISCUSSION DRAFT]

119TH CONGRESS
1ST SESSION

H. R. _____

To require auditor independence standards of the Public Company Accounting Oversight Board and the Securities and Exchange Commission applicable to past audits of a company occurring before it was a public company to treat an auditor as independent if the auditor meets established professional standards, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

Mrs. MCCLAIN introduced the following bill; which was referred to the Committee on _____

A BILL

To require auditor independence standards of the Public Company Accounting Oversight Board and the Securities and Exchange Commission applicable to past audits of a company occurring before it was a public company to treat an auditor as independent if the auditor meets established professional standards, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AUDITOR INDEPENDENCE FOR CERTAIN PAST AUDITS OCCURRING BEFORE AN ISSUER IS A PUBLIC COMPANY.

(a) AUDITOR INDEPENDENCE STANDARDS OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD.—Section 103 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7213) is amended by adding at the end the following:

"(e) AUDITOR INDEPENDENCE FOR CERTAIN PAST AUDITS OCCURRING BEFORE AN ISSUER IS A PUBLIC COMPANY.—With respect to an issuer that is a public company or an issuer that has filed a registration statement to become a public company, the auditor independence rules established by the Board with respect to audits occurring before the last fiscal year of the issuer completed before the issuer filed a registration statement to become a public company shall treat an auditor as independent if—

"(1) the auditor is independent under standards established by the American Institute of Certified Public Accountants applicable to certified public accountants in United States; or

"(2) with respect to a foreign issuer, the auditor is independent under comparable standards applicable to certified public accountants in the issuer's home country.".

(b) AUDITOR INDEPENDENCE STANDARDS OF THE SECURITIES AND EXCHANGE COMMISSION.—Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1) is amended by adding at the end the following:

"(n) AUDITOR INDEPENDENCE FOR CERTAIN PAST AUDITS OCCURRING BEFORE AN ISSUER IS A PUBLIC COMPANY.—With respect to an issuer that is a public company or an issuer that has filed a registration statement to become a public company, the auditor independence rules established by the Commission under the securities laws with respect to audits occurring before the last fiscal year of the issuer completed before the issuer filed a registration statement to become a public company shall treat an auditor as independent if—

"(1) the auditor is independent under standards established by the American Institute of Certified Public Accountants applicable to certified public accountants in United States; or

"(2) with respect to a foreign issuer, the auditor is independent under comparable standards applicable to certified public accountants in the issuer's home country.".

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