

## *Recent SEC Rules and Announcements Impacting Small Public Companies*

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### **Introduction**

On December 19, 2007, the Securities and Exchange Commission (the "SEC") adopted a final rule that expands the number of public companies that qualify for scaled disclosure requirements. One of the biggest changes for small business issuers in Release 33-8876 is the elimination of Regulation S-B and all SB reporting forms (e.g. Forms 10-KSB, 10-QSB and SB-2) and the placement of the Regulation S-B information within separate paragraphs in Regulations S-K and S-X.

The status of a company as a non-accelerated filer will impact the requirement to provide auditor attestations on internal control over financial reporting mandated by Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX"). On June 26, 2008, the SEC adopted a rule extending the compliance dates for non-accelerated filers to provide auditor attestation on internal control over financial reporting until the first fiscal year ending on or after December 15, 2009. The recently adopted rules indicate that the SEC is placing greater importance on addressing the unique issues facing smaller companies in today's complex reporting environment.

### **A. Rule Expanding Eligibility for Smaller Company Regulation**

#### **1. New Category of "Smaller Reporting Companies"**

Pursuant to the new smaller reporting company rule, the term "smaller reporting company" replaced the term "small business issuer," which defined the companies eligible to use

Regulation S-B disclosure requirements. The smaller reporting company rule creates a new category of companies eligible for "smaller reporting company" status. A company that has less than \$75 million in public equity float on the last business day of the company's second fiscal quarter will qualify for the scaled disclosure requirements under the smaller reporting company rule. Companies without a calculable public equity float will qualify if their revenues were below \$50 million in the previous year. All reporting companies as of February 4, 2008 can determine if they qualify for smaller reporting company status based on the \$75 million in public float or \$50 million in annual revenue test. In contrast, the SEC's previous eligibility requirements for "small business issuer" status required that companies have both less than \$25 million in public common equity float and less than \$25 million in annual revenues. Accordingly, the new smaller reporting company rule increases the number of companies eligible for scaled disclosure requirements. It is worth noting however, that companies that are going public but that will not be listed and that had less than \$50 million in annual revenues will still need to count the aggregate amount they are raising, and if that amount together with the amount held by non-affiliates is more than \$75 million they will not qualify for scaled disclosure.

The SEC rule defining "smaller reporting companies" excludes investment companies, business development companies, and asset-

backed issuers. However, the smaller reporting company rule permits all foreign companies to qualify as “smaller reporting companies” if they otherwise qualify and choose to file on domestic company forms and provide financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles.

## **2. Entering and Exiting Smaller Reporting Company Status**

The new rules on entering and exiting smaller reporting company status in Item 10 of Regulation S-K are less restrictive than the prior Regulation S-B requirements of Item 10.

Item 10 of Regulation S-B currently requires issuers to calculate eligibility based on public float and revenue levels for two consecutive fiscal years. The Regulation S-B system had a significantly longer transition period to enter or exit the smaller company disclosure system. Under the new rules, reporting companies will determine whether they qualify as a larger reporting company as of the last day of their second fiscal quarter. The new rules allow smaller reporting companies who determine that they now qualify as a larger reporting company to comply with the larger reporting company requirements in the first quarterly report in the fiscal year following the determination date. Larger public companies that determine, at the end of their second quarter, that they now qualify as a smaller reporting company may opt to provide scaled disclosure beginning with the Form 10-Q for their second fiscal quarter.

However, issuers should be aware that to reenter the scaled disclosure system, a company would be required to determine that its public float fell below \$50 million not \$75 million as of the last business day of its second fiscal quarter. If the calculation of public float is less than zero, because the issuer had no public equity outstanding or no market price for its equity existed, then such company would be required to determine that it had annual revenues less than \$40 million during its previous fiscal year before it would be eligible to reenter the scaled disclosure system.

Thus, although the new rules are designed to increase the number of companies eligible for scaled disclosure, companies whose float falls below \$75 million but not below \$50 million should be aware that they will be a smaller reporting company and an accelerated filer at the same time. A company must look to the definitions of “smaller reporting company” and “accelerated filer” in Rule 12b-2 under the Exchange Act to determine if it qualifies as a smaller reporting company and non-accelerated filer each year. A company qualifying as a smaller reporting company because it had less than \$75 million in public float on the last business day of the company’s second fiscal quarter may nonetheless remain an accelerated filer if it does not qualify to transition out of the definition of an “accelerated filer” pursuant to Rule 12b-2. For example, a company with a fiscal year ended December 31, 2007 could be both a smaller reporting company and an accelerated filer for 2008 if it was an accelerated filer with respect to filings due in 2007 and had a public float of \$60 million on the last business day of its second fiscal quarter of 2007. Such a company may use the scaled disclosure rules for smaller reporting companies in its annual report on Form 10-K because it had a public float of less than \$75 million on the last business day of the company’s second fiscal quarter. However, in order to qualify to transition out of “accelerated filer” status, the company would have had to have had a public float that falls below \$50 million instead of \$75 million at the end of its second fiscal quarter. Therefore, the company would not qualify to transition out of “accelerated filer” status and the company’s Form 10-K would be due 75 days after the end of its fiscal year, rather than the 90 days allowed for non-accelerated filers, and must include the SOX Section 404 auditor attestation report.

## **3. Scaled Disclosure Requirements**

The smaller reporting company rule integrates Regulation S-B into Regulation S-K, eliminating Regulation S-B altogether. The SEC Rule allows for smaller reporting companies to choose, on an item-by-item, or “a la carte” basis, to comply with either Regulation S-K or S-X scaled disclosure

requirements for smaller reporting companies or larger company disclosure requirements. A smaller reporting company can choose to use the requirements for one, some, all or none of the items, at its election, in any one filing. Eligible companies may elect to follow scaled financial statement requirements or to provide the larger company financial statement presentation on a quarterly basis, rather than electing the full fiscal year's financial presentation in the first quarterly report of the fiscal year, as was previously proposed. Below is a brief summary of certain of the scaled disclosures available to smaller reporting companies:

- Item 101 (Description of Business). Generally, the different requirements for smaller reporting companies under Item 101 involve providing a less detailed description of the company's business. For example, the Regulation S-K standard for Item 101 requires financial information about segments, which the standard for smaller reporting companies does not require. In addition, smaller reporting companies will be required to provide and disclose business development activities for only three years, instead of the five-year disclosure required of larger companies by Item 101 of Regulation S-K.
- Item 201 (Market Price of and Dividends on Registrant's Common Equity and Related Stockholder Matters). Smaller reporting companies are not required to provide a performance graph.
- Item 301 (Selected Financial Data); Item 302 (Supplementary Financial Information). Smaller reporting companies are not required to present the information required by these item requirements.
- Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations). Among other things, smaller reporting companies will: (i) provide only two years of analysis if the company is presenting only two years of financial statements, instead of the three years of analysis required of larger companies that are required to provide three years of financial statements; and (ii) not be required to provide tabular disclosure of contractual obligations.
- Item 305 (Quantitative and Qualitative Disclosures about Market Risk). Smaller reporting companies are not required to disclose Item 305 information.
- Item 402 (Executive Compensation). Smaller reporting companies will: (i) provide executive compensation disclosure for only three named executive officers (specifically including the principal executive officer but not the principal financial officer), rather than the five required of larger companies; (ii) provide the Summary Compensation Table disclosure for only two years, rather than the three years required of larger companies; (iii) not be required to provide a Compensation Discussion and Analysis; (iv) provide only three of the seven tables required of larger companies, i.e. the Summary Compensation Table, the Outstanding Equity Awards Table, and the Director Compensation Table; (v) provide alternative narrative disclosures; and (vi) not be required to include footnote disclosure of the grant date fair value of equity awards in the Director Compensation Table.
- Item 404 (Transactions with Related Persons, Promoters and Certain Control Persons). Smaller reporting companies will: (i) not be required to disclose policies and procedures for reviewing related person transactions, which is required of larger companies; (ii) be required to provide disclosure regarding a transaction where the amount exceeds the lesser of 1% of a smaller company's total assets or \$120,000; (iii) be required to provide additional specific information about underwriting discounts and commissions, and corporate parents; and (iv) be required to provide disclosure regarding promoters and certain control persons.
- Item 407 (Corporate Governance). Smaller reporting companies are: (i) not required to provide Compensation Committee Interlock and Insider Participation disclosure or a

Compensation Committee Report; and (ii) not required to provide an Audit Committee Financial Expert Report until the first annual report after their initial registration statement is filed with the SEC and becomes effective.

- Item 503 (Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges). Smaller reporting companies will not be required to provide or update risk factors in periodic reports. Also smaller reporting companies need not provide the information regarding the ratio of earnings to fixed charges when a registrant issues debt, or the ratio of combined fixed charges and preference dividends to earnings when a registrant issues preference equity securities.
- Item 601 (Exhibits). Smaller reporting companies need not provide Exhibit 12 (Statements re Computation of Ratios).

To the extent the smaller reporting company scaled item requirement is more rigorous than the same larger company item requirement, smaller reporting companies will be required to comply with the more rigorous, smaller reporting company item requirement. Currently, the smaller reporting company requirements under Item 404 of Regulation S-K present the only instance where the scaled requirements could be more rigorous than the larger company standard. This is because a smaller reporting company is required to provide disclosure on a related person transaction since the beginning of the company's last fiscal year if the amount involved in the transaction exceeds the lesser of \$120,000 or 1% of the average of the company's total assets at year end for the last two completed fiscal years. In contrast, a larger company reporting under the same Item 404 Regulation S-K requirement is required to provide disclosure on a related person transaction since the beginning of the last fiscal year if the transaction exceeds \$120,000. A smaller reporting company's related person transaction may more easily exceed 1% of the average of the smaller reporting company's total assets than \$120,000, as required for larger companies under the same item requirement.

## **B. Rule Extending Section 404 Compliance Dates**

On June 5, 2003 the SEC adopted certain amendments to SOX Section 404 that require companies, other than registered investment companies, to include in their annual reports filed with the SEC a report of management, and an accompanying auditor's attestation report, on the effectiveness of the company's internal control over financial reporting. In addition, the amendments require companies to evaluate, as of the end of each fiscal quarter, or year in the case of a foreign private issuer filing its annual report on Form 20-F or Form 40-F, any change in a company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Since Section 404 was adopted, the SEC has issued a series of releases that extend the Section 404 compliance date for non-accelerated filers. Due to the recently adopted smaller reporting company rule, many (but not all) smaller reporting companies will also qualify for non-accelerated filer status.

The most recent extension for non-accelerated filers is set forth in a recently adopted rule issued on June 26, 2008. The rule provides that non-accelerated filers are required to provide an auditor's attestation report for the first fiscal year ending on or after December 15, 2009. However, non-accelerated filers must still furnish management's report on internal control over financial reporting during this period. A non-accelerated filer will be required to state in its management report on internal control over financial reporting that the company's annual report does not include an auditor attestation report.

Management's report on internal control over financial reporting will be considered "furnished" rather than "filed" and therefore not be subject to liability under Section 18 of the Exchange Act of 1934 (the "Exchange Act"). This decision was made, in part, due to the risk that management

may conclude that the company's internal control over financial reporting is effective when the management report is filed without the auditor's attestation report, but the company's auditor may come to a contrary conclusion in its report filed in a subsequent year, and as a result, the company's previous assessment may be called into question. To reduce the liability risk associated with such second-guessing, until such time as non-accelerated filers are required to comply with both the SOX Section 404(a) and 404(b) requirements, the management report will be considered "furnished" rather than "filed." However, the SEC noted in the rule that material misstatements or omissions in management's report on internal control over financial reporting, regardless of whether the report is "furnished" or "filed," are subject to liability under Section 10(b) and Rule 10b-5 under the Exchange Act.

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