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SEC Adopts Amendments to Disclosure and Reporting Requirements for Smaller Companies

The SEC has adopted amendments, substantially as proposed, to its disclosure and reporting regimes under both the Securities Act and the Exchange Act to extend the benefits of the scaled disclosure and reporting requirements currently in place for small business issuers to a much larger group of companies. The amendments will create a new category of issuers called "smaller reporting companies," which will include most companies with a public float below $75 million. While the amendments will maintain the disclosure requirements currently contained in Regulation S-B, they will integrate the provisions of Regulation S-B into Regulation S-K and, in one instance, Regulation S-X. In addition, the amendments will phase out the "SB" forms currently used by small business issuers in connection with the registration of their securities and periodic reporting and provide for registration and reporting by smaller reporting companies on the forms currently used by larger companies.

Some of the substantive differences between the final rule and the proposed rule are the following:

- Rule 3-05 of Regulation S-X sets forth the requirements to include financial statements for acquired businesses. Currently, reporting companies that are otherwise required to include three years of audited financial statements for an acquired business are permitted to include only two years if the net revenues of the acquired business are less than $25 million for its latest fiscal year. The amendments increase this net revenue threshold to $50 million. This change will benefit all reporting companies (and not just smaller reporting companies);

- a new Article 8 will be added to Regulation S-X to set forth the scaled financial statement disclosure requirements currently included in Item 310 of Regulation S-B; and

- smaller reporting companies will be permitted to choose to comply with non-financial and financial disclosure requirements on an "a la carte" basis in their Securities Act and Exchange Act filings. The SEC did not adopt its proposal that would have required smaller reporting companies to provide financial statements in accordance with either the scaled financial statement requirements or the larger company financial statement requirements for an entire fiscal year.

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The amendments will be effective February 4, 2008, except that Form 10-QSB will be removed effective October 31, 2008 and Form 10-KSB will be removed effective March 15, 2009. Current small business issuers have the option to file their next annual report for a fiscal year ending on or after December 15, 2007 on either Form 10-KSB or Form 10-K. A small business issuer may continue to file its periodic reports using Regulation S-B and the "SB" forms until the next annual report described in the preceding sentence is filed. After that next annual report is filed, such company will be required to file quarterly reports on Form 10-Q and annual reports on Form 10-K, and may elect to comply with the new scaled disclosure requirements of Regulation S-K. Companies newly qualifying as smaller reporting companies have the option to use the new scaled Regulation S-K requirements when filing their next periodic report due after February 4, 2008. If a registration statement under the Securities Act was filed on an "SB" form before the effective date, and the company amends it after such date, the company must file the amendment on the correct form (e.g., Form S-1), but may continue to use the disclosure format and content based on the "SB" form for six months.

Expanding Eligibility for Smaller Company Scaled Regulation

In March 2005, the SEC formed the Advisory Committee on Smaller Public Companies. Its task was to assess the regulatory system for smaller companies under the federal securities laws. The amendments described in this memorandum stem from recommendations of the Advisory Committee and are intended to simplify, and expand significantly eligibility to use, the scaled disclosure and reporting regimes available to smaller companies, consistent with investor protection. According to the SEC, the amendments make such scaled disclosure and reporting regimes available to approximately 4,976 companies, which constitutes 42% of the 11,898 companies that filed annual reports under the Exchange Act in 2006, a significant increase from the 3,395 reporting companies that currently use the scaled disclosure and reporting regimes.

Quantitative Standards in the Definition of "Smaller Reporting Company"

Public Float of Less than $75 Million

The new category of "smaller reporting companies," will replace the category of "small business issuer," which is defined as a U.S. domestic or Canadian company with revenues and a public float of less than $25 million each that is not an investment company or asset-backed issuer. The new maximum public float of $75 million set forth in the amendments is intended to harmonize the eligibility for smaller reporting company status with certain other federal securities law areas, such as the accelerated filer definition and Form S-3 eligibility.

Unlike the definition of "small business issuer," the definition of "smaller reporting company" will not include a revenue test for most companies. Under the amendments, the public float of an Exchange Act reporting company will be calculated annually by multiplying the number of outstanding shares of common equity held by non-affiliates by the price at which its common equity was last sold or the average of the bid and ask prices of its common equity in the public market as of the last business day of the company's second fiscal quarter. This annual determination date is consistent with the current practice for establishing accelerated filer status.

In connection with a Securities Act registration statement for an initial public offering of common equity, however, a company will calculate its public float as of a date within 30 days of the date it files the initial registration statement. Such a non-reporting company will compute public float by multiplying the aggregate of the number of outstanding shares of common equity held by non-affiliates before the public offering plus the number of such shares included in the

registration statement by the estimated public offering price of the shares. This method of calculation represents a departure from current practice in determining public float for purposes of establishing "small business issuer" status, which is calculated based only on the number of shares of common equity outstanding before the public offering without consideration of the shares included in the registration statement.

Additionally, the amendments provide a company conducting an initial public offering the option to recalculate public float when the company completes its initial public offering. For example, if a company files an initial public offering registration statement based on the larger company Regulation S-K requirements but then determines after the close of the initial public offering that its public float is below $75 million, such company would qualify as a smaller reporting company eligible to provide scaled disclosure in the first periodic report due after the registration statement was declared effective. However, a smaller reporting company would not be required to transition its disclosure to the larger company requirements if its public float rose above $75 million during the pre-effective stage of filing if the company made a bona fide eligibility determination at the time it filed the registration statement. In such instance, the company would continue to be a smaller reporting company until its next annual determination date.

In an initial Exchange Act registration statement covering a class of securities, a company will calculate its public float as of a date within 30 days of the date it files such registration statement. Because such an Exchange Act registration statement will not directly affect the company's public float, if a company that files an Exchange Act registration statement does not have a public float or its public float cannot be calculated because there is no market price for its equity securities, the company's qualification as a "smaller reporting company" will be based on its annual revenues, as described below.

Annual Revenues of Less than $50 Million

While the definition of "smaller reporting company" does not generally apply a revenue standard, a company that does not have a public float because it has no significant public common equity or no market price exists for its common equity (such as a company with only debt publicly outstanding) may qualify as a "smaller reporting company" if it has reported annual revenues of less than $50 million in its most recently completed fiscal year for which audited financial statements are available.

Exclusions from the Definition of "Smaller Reporting Company"

Under the amendments, the definition of "smaller reporting company" will continue to exclude investment companies and asset-backed issuers, but all foreign companies that meet the applicable quantitative standards will be able to qualify as smaller reporting companies. For this reason, a foreign private issuer that also qualifies as a smaller reporting company will be able to choose whether to provide disclosure based on (a) the domestic forms with the scaled reporting requirements for smaller reporting companies as long as it presents U.S. GAAP financial statements or (b) the foreign private issuer forms with the disclosure requirements of those forms unaffected by smaller reporting company status.

Canadian Filers

Currently, Canadian companies that are small business issuers are permitted to provide Canadian GAAP financial statements that are reconciled to U.S. GAAP in their "SB" Securities Act and Exchange Act filings. The amendments eliminate this accommodation and will require instead that Canadian companies qualifying as smaller reporting companies, that choose to avail themselves of the option to provide scaled disclosure in U.S. domestic company forms, present U.S. GAAP financial statements. The SEC believes that the regulatory scheme for foreign private issuers on the "F" forms is specifically tailored to address their special circumstances and provides the accommodations most useful to such companies.

Integration of Requirements of Current Regulation S-B into Regulations S-K and S-X

Under the amendments, the provisions of Regulation S-B will be integrated into Regulation S-K and Regulation S-X. Except as described below, the disclosure requirements for smaller reporting companies will remain substantially the same.

Substantive Changes from Current Requirements of Regulation S-B

Item 310: Financial Statements

Under the amendments, a new Article 8 will be added to Regulation S-X to set forth the alternative requirements on form and content of financial statements for smaller companies that now appear in Item 310 of Regulation S-B. This is a departure from the proposed amendments which proposed adding a new Item 310 to Regulation S-K. Two substantive changes in the new Article 8 of Regulation S-X will differentiate it from current Item 310 of Regulation S-B. First, the amendments will require two years of comparative audited balance sheet data for smaller reporting companies, rather than the one year currently permitted under Regulation S-B. Secondly, as noted above, Canadian smaller reporting companies will be required to present U.S. GAAP financial statements.

Item 404: Transactions with Related Persons, Promoters, and Certain Control Persons

Item 404 of Regulation S-B requires disclosure regarding transactions with related persons, promoters, and certain control persons where the amount exceeds the lesser of 1% of a small business issuer's total assets (based on the average of total assets at year end for the last three completed fiscal years) or $120,000, while companies using Regulation S-K are required to disclose information only about such transactions where the amount exceeds $120,000. Because of this difference, a small business issuer may currently be required to provide more rigorous disclosure under Item 404 than a larger company if 1% of its total assets is less than $120,000. Small business issuers are also currently required to disclose additional specific information about underwriting discounts and commissions and corporate parents. The amendments do not eliminate or change these greater disclosures for smaller reporting companies.

The amendments will change the calculation of total assets for smaller reporting companies from 1% of their total assets based on the average of total assets at year end for the last three completed fiscal years to the last two completed fiscal years. This standard is consistent with the two years of audited financial statements required to be filed by smaller reporting companies.

Substantive Changes from Current Requirements of Regulation S-X

Rule 3-05: Financial Statements of Businesses Acquired or to Be Acquired

As noted above, Rule 3-05 of Regulation S-X currently permits reporting companies that are otherwise required to include three years of audited financial statements for an acquired business to include only two years of audited financial statements if the net revenues reported by the acquired company for the latest fiscal year are less than $25 million. In light of the $50 million in revenues threshold adopted for determining smaller reporting company status, the amendments will increase the Rule 3-05 threshold to $50 million in net revenues. This amendment to Rule 3-05 will benefit all reporting companies, both large and small, who acquired businesses with annual revenues of less than $50 million.

A La Carte Approach

In order to encourage smaller reporting companies to determine for themselves the proper balance and mix of disclosure for their investors, companies that qualify as smaller reporting companies will be permitted to choose on an item-by-item, or "a la carte," basis to comply with either the scaled disclosure requirements for smaller reporting companies or the more rigorous disclosure requirements for larger companies. The SEC believes that smaller reporting companies should be permitted to choose to comply with non-financial and financial requirements on an item-by-item basis when such choices are consistent with the legal requirements under the federal securities laws. For this reason, the SEC did not adopt its proposal to require smaller reporting companies to provide financial statements on the basis of the scaled financial statement requirements or the larger company financial statement requirements for a single fiscal year, and not switch back and forth from one to the other in different filings within a single fiscal year.

Eliminating S-B Forms

The amendments will phase out forms associated with Regulation S-B (including Forms 10-SB, 10-QSB, 10-KSB, SB-1, and SB-2) and instead add a check box to the cover page of all forms in which smaller reporting companies may take advantage of the alternative disclosure requirements. The check box will require smaller reporting companies to indicate their status as such and therefore alert investors and others reviewing the filing that the disclosing company is eligible to comply with the scaled disclosure requirements available to smaller reporting companies.

One notable result of this elimination of the forms associated with Regulation S-B is that most smaller reporting companies will be able to use Form S-1 to offer securities to the public instead of Form SB-1. Unlike the "SB" forms, Form S-1 permits an Exchange Act reporting issuer to incorporate by reference its previously filed Exchange Act reports if it (a) has filed an annual report for its most recently completed fiscal year, (b) has filed all reports and other materials required to be filed by Exchange Act Sections 13(a), 14, or 15(d) during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (c) makes available all incorporated materials on its Internet site. This ability to incorporate previously filed reports by reference is expected to result in some cost savings and efficiencies in preparing registration statements for smaller reporting companies.

Transition to and from Smaller Reporting Company Status

Transition from Smaller Reporting Company Status

Under the current regulatory regime, a small business issuer that exceeds the $25 million revenue and $25 million public float ceilings at the end of two consecutive fiscal years must transition out of small business issuer status, effective immediately for filings covering events and completed fiscal periods in the next fiscal year. The amendments will follow the transition model currently used to determine accelerated filer status, and smaller reporting companies will lose eligibility to claim that status in the first fiscal year following a fiscal year in which the smaller reporting company's public float rises above $75 million as of the last business day of the second fiscal quarter.

Transition to Smaller Reporting Company Status

Under the current regulatory regime, a reporting company may transition to small business issuer status in the next fiscal year if its revenues and public float fall below $25 million at the end of two consecutive fiscal years. The amendments will again follow the transition model currently used to determine accelerated filer status, and a reporting company that does not file reports claiming smaller reporting company status will transition to that status if its public float falls below $50 million as of the last business day of the company's second fiscal quarter. Such a company is permitted to use the scaled disclosure requirements in the Form 10-Q quarterly report for the company's second fiscal quarter rather than, as proposed, the following fiscal year's first quarterly report.

Under the amendments, companies that do not have a public float because they have no significant public common equity or no market price exists for their common equity and that have less than $50 million in annual revenues will qualify as smaller reporting companies and be eligible to use the scaled disclosure requirements until they exceed $50 million in annual revenues. Once a company fails to qualify for smaller reporting company status under this revenue test, it will remain unqualified unless its annual revenues fall below $40 million during the previous fiscal year.

Elimination of Transitional Small Business Issuer Format

The "transitional small business issuer format" associated with Form SB-1 and Form 10-KSB was intended to ease the transition from non-reporting to reporting status for small business issuers preparing disclosure on initial registration statements and annual reports. Because the transitional disclosure format is infrequently used, the amendments will eliminate this disclosure option, and smaller reporting companies will instead use Form S-1 and 10-K.

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This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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