Latham & Watkins Capital Markets Practice

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From Ducklings to Swans: More Companies Will Qualify as a "Smaller Reporting Company"

SEC rule amendments expand the scope of scaled disclosure accommodations, which may offer disclosure relief to additional small cap and pre- and low-revenue issuers.

Key Points:

- The SEC has provided disclosure relief to a larger range of small cap public companies as well as mid-cap public companies with annual revenues of less than US$100 million.
- These companies, and similar companies in the IPO pipeline, should consider taking advantage of this opportunity to omit information that can be costly to provide if not material for investors.

Background

In the fairy tale *The Ugly Duckling*, an ordinary waterfowl is magically transformed overnight into the most beautiful swan on the lake. The Securities and Exchange Commission (SEC), through its own considerable powers, has amended its rules to permit an expanded flock of companies to transform themselves into smaller reporting companies (SRCs), enabling them to take advantage of reduced financial, compensation, and other disclosure obligations in SEC filings. Although the SEC referred to the overall impact of these changes as "modest," Latham believes that the effect will likely be manifest and much appreciated among small cap and qualifying pre-revenue and low-revenue companies.

This *Client Alert* describes the SEC's action and the new black letter SRC rules, as well as next steps that current public companies, and companies planning an IPO, should consider in anticipation of the new rules becoming effective on September 10, 2018.

What action did the SEC take?

The SEC amended the definition of "smaller reporting company" in rules under the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act).

What was the old definition?

Prior to the amendments, a company initially qualified as an SRC if it had either (1) a "public float" of less than US$75 million, or (2) no public float and annual revenues of less than US$50 million. A company that did not qualify as an SRC could only claim SRC status if it had a public float of less than $50 million, or no public float and annual revenues of less than $40 million during its previous fiscal year. Only a limited number of companies qualified under these thresholds.

What is the new definition?

An SRC is now defined as an issuer with either:

- A public float of less than US$250 million
- A public float of less than US$700 million (including having no public float) and annual revenues of less than US$100 million

How are these thresholds applied?

For an already reporting company, public float is measured as of the last business day of a company's most recently completed second fiscal quarter — *i.e.*, June 30 for a company with a December 31 fiscal year-end. Public float is the aggregate worldwide number of shares of a company's voting and non-voting common equity held by non-affiliates, multiplied by the price at which the common equity was last sold — or the average of the bid and asked prices of common equity — in a company's principal trading market.

For an IPO company, public float is based on the estimated public offering price of the shares, and the number of shares estimated to be outstanding and not held by affiliates after the IPO. Companies have the option to re-determine their SRC status at the conclusion of the IPO, based on the actual offering price and shares outstanding.

Annual revenues are determined as of the most recently completed fiscal year for which audited financial statements are available.

What types of companies will most likely qualify as SRCs under the new rules?

The authors of this *Client Alert* believe that many tech-oriented companies will qualify as SRCs, including life science companies, biotech companies, and other types of technology companies that have yet to launch their products or services on a large scale. These companies are often referred to as "pre-revenue companies" because they undertook (or are planning to undertake) an IPO, in part to fund ongoing growth and strategic projects that they anticipate offering to customers in the near- to mid-term.

What are the benefits of being an SRC?

SRCs can take advantage of several "scaled disclosure" accommodations. For example, an SRC may:

- Omit the third year back of audited financial statements and the related Management's Discussion and Analysis (MD&A)
- Omit the Compensation Discussion and Analysis (CD&A) section of a proxy statement or Form 10-K
- Omit Pay Ratio disclosure

In addition:

- Compensation disclosure required by Item 402 of Regulation S-K need only cover three named executive officers (instead of the normal five named executive officers)
- The Summary Compensation Table need only go back two years (instead of the normal three years)
- The Compensation Committee report is not required

For a list of the scaled disclosure accommodations available to SRCs, please see the chart at the end of this *Client Alert.*

Can an SRC nonetheless continue to comply with some of the regular disclosure requirements as if it were not an SRC?

Yes. An SRC may comply with the scaled disclosure requirements on an item-by-item basis. For example, an SRC may choose to continue to provide a full three years of audited financial statements and related MD&A, but omit the CD&A.

Are SRCs subject to any additional disclosure requirements?

Yes – SRCs are subject to additional disclosure requirements with respect to related-person transactions: rather than the flat US$120,000 threshold under Item 404 of Regulation S-K, the threshold is the lesser of US$120,000 or 1% of total assets, and the disclosure must go back two years. SRCs are also subject to additional Item 404 disclosure requirements relating to the company's parent and related persons receiving underwriting compensation. SEC statements indicate that this additional disclosure is mandatory for any company that qualifies as an SRC, even if it does not use any of the scaled disclosure accommodations.

What are the initial qualification thresholds for SRC status under the new rules and when are they tested?

A company will generally determine its SRC status at the time of its IPO or other initial SEC registration, and after that on an annual basis at the end of its second fiscal quarter. Importantly, there are lenient transition provisions for existing Exchange Act reporting companies as the rules become effective.

1. Newly IPOing companies

Companies assess their SRC status at the time they confidentially submit or publicly file their Form S-1 registration statement. This determination is based on revenues for the latest fiscal year and public float, as described above, using the price range and estimate of shares to be outstanding after the IPO.

2. Current Exchange Act reporting companies

In general, if a company does not qualify as an SRC, it can transition into SRC status only if the company meets lower public float / revenue thresholds, as described below. However, the SEC has provided an accommodation as the rule amendments are becoming effective. For the first fiscal year after September 10, 2018, existing public companies may qualify by applying the new initial qualification thresholds rather than the lower subsequent qualification thresholds. A calendar year company will test its status based on its revenues for the year ended December 31, 2017 and its public float as of June 29, 2018.

Calendar year companies that are newly eligible SRCs may check the "smaller reporting company" box and use the scaled disclosure accommodations in their Form 10-Q for the quarter ended September 30, 2018.

3. **Subsequent qualification thresholds**

After a company fails to qualify as an SRC, it remains unqualified unless it meets **lower public float / revenue thresholds**. These lower thresholds are designed to avoid having companies frequently change into and out of SRC status. The subsequent qualification thresholds are:

- Public float of less than US$200 million if the company previously had a public float of US$250 million or more
- Annual revenue of less than US$80 million if the company's annual revenues were previously US$100 million or more, and a public float of less than US$560 million if the company had a public float of US$700 million or more

How does a company transition into SRC status?

As soon as a company determines that it qualifies as an SRC, it may apply the scaled disclosure accommodations available to SRCs in its next Exchange Act filing. As noted, calendar year companies that are newly eligible SRCs may use the accommodations in their Form 10-Q for the quarter ended September 30, 2018.

How does a company transition out of SRC status?

When a company no longer qualifies as an SRC as of the end of its most recently completed second fiscal quarter, it can continue to use the scaled disclosure accommodations available to SRCs through the company's next annual report on Form 10-K. The filing deadline for the Form 10-K will be based on the company's filing status as of the end of the fiscal year covered by the Form 10-K. The company would not be permitted to use scaled disclosure in its subsequent quarterly reports on Form 10-Q.

Is an SRC required to provide an auditors' attestation report under Section 404(b) of the Sarbanes-Oxley Act?

It depends. Only non-accelerated filers and emerging growth companies are exempt from the requirement to provide an auditors' attestation report. Under the amended SRC rules, a company's filing status as an accelerated filer is separate from its SRC status. As a result, a company could possibly qualify as an SRC (and thus be able to provide scaled disclosure) but also qualify as an accelerated filer (and thus be required to provide a SOX 404(b) attestation report). In a hopeful sign, SEC Chairman Jay Clayton has directed the SEC Staff to develop recommendations for exempting some companies from the SOX 404(b) requirement.

Can foreign private issuers (FPIs) qualify as SRCs and use the scaled disclosure accommodations?

Yes; however, a foreign company can qualify as an SRC only if it chooses to file on domestic forms (Form 10-K, S-1, *etc.*) and provide US GAAP financial statements.

Are other types of companies entirely disqualified from SRC status, even if they meet the thresholds?

Yes. Companies that are majority-owned by a non-SRC, as well as asset-backed issuers and investment companies, can never qualify as an SRC.

What steps should a company take if it will now qualify as an SRC, and may take advantage of the scaled disclosure accommodations?

A company that is planning an IPO should consult with its bankers and other advisers as to the potential impact (if any) on pricing, liquidity, and overall market acceptance of taking advantage of some or all of the scaled disclosure accommodations.

As with any material change impacting a listed company, senior management should consult with appropriate constituencies — such as major shareholders, lead investors, key customers or suppliers, significant creditors or lenders, important analysts, and employee representatives — before deciding to omit some or all of previously provided disclosure. Management should be prepared to explain the direct and indirect costs associated with providing such disclosure, as well as to communicate its understanding that investors and others do not find the disclosure relevant or useful.

Through these practical measures, newly minted SRCs may indeed find their own "happily ever after" under the expanded qualification thresholds.

REGULATION S-K

Item	*Scaled Disclosure Accommodation*
101 Description of Business	Description of development of registrant's business reduced from five-year period to three-year period Less detailed business development description
201 Market Price of and Dividends on the Registrant's Common Equity and Related	Stock performance graph not required
301 Selected Financial Data	Not required
302 Supplementary Financial Information	Not required
303 Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)	Two-year MD&A comparison (reduced from three years) Two-year discussion of impact of inflation and changes in prices (reduced from three) Tabular disclosure of contractual obligations not required
305 Quantitative and Qualitative Disclosures About Market Risk	Not required
402 Executive Compensation	Three named executive officers (reduced from five) Two years of summary compensation table information (reduced from three) May omit: • Compensation discussion and analysis • Grants of plan-based awards table • Option exercises and stock vested table • Pension benefits table • Nonqualified deferred compensation table • Disclosure of compensation policies and practices related to risk management • Pay ratio disclosure
404 Transactions With Related Persons, Promoters, and Certain Control Persons	May omit description of policies/procedures for review, approval, or ratification of related party transactions However, expanded disclosure on specified related party transactions.

REGULATION S-K

Item	*Scaled Disclosure Accommodation*
407 Corporate Governance	Audit committee financial expert disclosure not required in first annual report Compensation committee interlocks and insider participation disclosure not required Compensation committee report not required
503 Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges	May omit: • Ratio of earnings to fixed charges disclosure • Risk factors in Exchange Act filings
601 Exhibits	May omit statements regarding computation of ratio

REGULATION S-X

Rule	*Scaled Disclosure*
8-02 Annual Financial Statements	Two years audited financial statements
8-03 Interim Financial Statements	May substitute certain historical financial data for separate historical financial statements of equity investees May omit subsidiary guarantor information (only required annually) Compliance with Regulation S-X Article 10 is not required
8-04 Financial Statements of Businesses Acquired or to Be Acquired	Maximum of two years of acquiree financial statements (reduced from three)
8-05 Pro forma Financial Information	Fewer circumstances under which pro forma financial statements are required
8-06 Real Estate Operations Acquired or to Be Acquired	Maximum of two years of financial statements for acquisition of properties from related parties (reduced from three)
8-08 Age of Financial Statements	Less stringent staleness rules for financial statements

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Financial Statement Requirements in US Securities Offerings

The Latham US IPO Guide