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SEC Approves Rules to Improve Small Business Regulation

November 2007

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Introduction

On November 15, 2007, the Securities and Exchange Commission ("SEC") addressed certain key recommendations made in the final report of the SEC Advisory Committee on Smaller Public Companies and adopted rules designed to modernize and improve reporting, capital-raising and disclosure requirements for small companies. These rules include, among other changes:

- shortening the holding periods under Rule 144 of the Securities Act of 1933 (the "Securities Act") for restricted securities of public companies from one year to six months to help reduce the cost of capital;
- making scaled disclosure regulations with reduced disclosure obligations available to an estimated additional 1,500 companies that qualify as "smaller reporting companies"; and
- creating two new exemptions for compensatory employee stock options, so that the registration requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), will not be triggered solely by a company's compensation decisions.

The rationale for the adoption of these rules, according to SEC Chairman Christopher Cox, arises from the substantial role small businesses play in the U.S. economy. The rules are intended mainly to enable smaller companies to raise capital more effectively, ease some of the burdens of the SEC's reporting and disclosure requirements, and increase the number of smaller companies eligible to comply with the scaled disclosure requirements.

This client alert will summarize each of the three new rules.

Part I – Revisions to Securities Act Rule 144 and Rule 145

While the revisions to Rule 144 and Rule 145 will apply to both larger and smaller companies, these revisions are primarily designed to benefit smaller companies, and enhance their access to the private markets. The adoption of the amendments is expected to reduce the cost to issuers of raising capital through private placements by making restricted securities more liquid. The impact of the increased liquidity may be a reduction in the so-called "liquidity discount" that investors receive to purchase equity securities in private placements.

A. Rule 144 Holding Period Requirements

1. Background

Rule 144 provides selling securityholders with a safe harbor exemption under Section 4(1) of the Securities Act for the resale of their securities, so that – provided the resale satisfies certain criteria – the holders are deemed not to be engaged in a distribution of securities. As a result, the selling securityholder is not classified as an "underwriter," and may sell the securities without registration.

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Rule 144 applies to the resale of restricted securities, including securities purchased in a private placement, or prior to an issuer's initial public offering. In 1997, the SEC amended Rule 144 to reduce the required holding period for both affiliates and non-affiliates under Rule 144(d) from two years to one year, and the required holding period for non-affiliate holders to sell an unlimited amount of securities under Rule 144(k) was reduced from three years to two years.

As a general rule, Rule 144 currently requires that before restricted securities may be resold, there must be a holding period of one year, beginning on the date the full purchase price or other consideration is paid by the purchaser. This holding period helps ensure that the purchaser of securities in a private placement has assumed the economic risks of investment and is not acting as a conduit for the sale to the public of unregistered securities on behalf of an issuer.

2. New Rules Shorten Holding Period Requirements

Based on its observations since the implementation of the 1997 amendments, the SEC is now satisfied that a holding period of six months for restricted securities of public companies held by affiliates and non-affiliates constitutes a reasonable indication that an investor has assumed the economic risk of investment in Rule 144 securities. The SEC's decrease of the holding period from one year to six months is designed to prevent the required holding period from both being longer than necessary and imposing unnecessary costs or restrictions on capital formation. This shorting of the holding period may have the practical effect of (a) making it less burdensome to issue securities in private placements and (b) potentially reducing the discount to market price that investors pay to purchase securities in private placements, due to the so-called "liquidity discount." This amendment was principally designed to benefit smaller companies with capital needs, but will also benefit larger companies as well, as the rules will also be available to their investors.

For issuers that are not Exchange Act reporting companies at the time of the relevant private placement, the new rules – consistent with current Rule 144 – will continue to require that the holding period for the restricted securities will be one year for both affiliates and non-affiliates. However, once the resale restrictions imposed on non-affiliates of these companies after the one-year holding period are eliminated, non-affiliates of these companies will not be subject to other Rule 144 conditions after satisfying this one-year holding period. For IPO companies, this means that sales by non-affiliates may begin, without limitation, once the investor has held its securities for one year.

B. Other Revisions to Rule 144

1. Manner of Sale Requirements

a. Background

Rule 144(f) previously required that securities be sold in "brokers' transactions" (as the term is defined in Section 4(4) of the Securities Act) or that securities be sold with a "market maker" (as the term is defined in Section 3(a)(38) of the Exchange Act). Rule 144(f) also previously prohibited a seller from (a) soliciting or arranging for the solicitation of orders to buy securities in anticipation of, or in connection with, a Rule 144 transaction or (b) making any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities.

The SEC indicated in its 1997 proposing release that it contemplated eliminating the manner of sale requirements entirely. However, the proposal was not adopted at that time. The June 2007 proposing release for the new rules articulates the SEC's original position that brokers, as financial intermediaries, serve an important function as gatekeepers for promoting compliance with Rule 144, and states the SEC's concern that "eliminating the manner of sale limitations for equity securities may lead to abusive transactions." Some of the commentary received with respect to this concern indicated that the manner of sale requirements should be eliminated completely because, among other things, (a) the holding period requirements of Rule 144 should generally suffice to achieve the non-distribution purposes of the rule, (b) these requirements limit the form of offerings and the development of market practices, and reduce liquidity and (c) Rule 144 compliance can be achieved by using certificates bearing restrictive legends, rather than by brokers serving a "gatekeeper" function.

In contrast to its concerns regarding equity securities, the SEC indicates in the June 2007 proposing

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release that fixed income securities, including asset-backed securities, do not raise the same concerns as equity securities, and that the manner of sale provisions with respect to the resale of fixed income securities are unduly burdensome. The June 2007 proposing release notes that fixed income securities are traded in dealer transactions in which the dealer seeks buyers for securities to fill sell orders, instead of through the means prescribed in Rule 144(f). For these reasons, the SEC stated in the June 2007 proposing release that the manner of sale restrictions should be eliminated as to fixed income securities.

b. Revision of Manner of Sale Requirements for Equity Securities; Elimination of Manner of Sale Requirements for Debt Securities

Affirming its stance in the June 2007 proposing release, the SEC's new rules will eliminate entirely the manner of sale limitations for debt securities. Additionally, because the SEC was persuaded to a greater degree by the comments it received in response to the June 2007 proposing release regarding equity securities, the new rules will revise the manner of sale provisions relating to affiliates' sales of equity securities.

By enacting such rules, the SEC sends a positive message to purchasers of equity securities, insofar as it perceives the risk for abusive transactions being outweighed by the benefit of removing certain unnecessary restraints on otherwise permissible sales. Moreover, by eliminating the manner of sale restrictions on fixed income securities – whose purchasers typically include financial institutions, pension funds, insurance companies, mutual funds, and other asset managers – the SEC has endeavored to facilitate a more liquid and robust market in the tradability of asset-backed and other fixed-income securities.

2. Form 144 Filing Thresholds

a. Background

The current Rule 144(h), which requires notice filings of proposed sales, has been in place since Rule 144's initial adoption in 1972. Rule 144(h) currently requires a notice on Form 144 to be submitted to the SEC if a selling securityholder intends to sell securities under Rule 144 that exceed 500 shares or an aggregate sale price of $10,000 within a three-month period.

b. Adoption of Higher Thresholds for Form 144 Filings

In accordance with its proposal in the June 2007 proposing release, the SEC has amended Rule 144(h) to increase the Form 144 filing threshold amount to trades of 1,000 shares or $50,000 within a three-month period. Only affiliates of issuers will be required to file this notice when relying on Rule 144, and these requirements will no longer apply to non-affiliates. The SEC expects that this amendment will substantially reduce the Form 144 filing requirements for affiliates of public companies.

3. Simplification of Preliminary Note and Codification of Certain SEC Staff Interpretations

In addition to the new rules noted above, the new amendments will also amend Rule 144 in the following ways:

- streamline the introductory note to Rule 144 to clarify in "plain English" that any person who sells restricted securities – and any affiliate or person who sells restricted securities on behalf of an affiliate – will not be deemed to be engaged in a distribution of the securities, and therefore will not be deemed an underwriter with respect to the transaction in which the securities are sold if the sale is made in accordance with the provisions of Rule 144; and
- codify certain staff interpretations of the SEC's Division of Corporation Finance to facilitate market participants' understanding and compliance with Rule 144.

C. "Tolling Provision" Relating to Holding Period for Hedging Transactions Not Adopted

1. Background

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In the June 2007 proposing release, the SEC expressed its concern about hedging transactions with respect to resales of restricted securities, insofar as these transactions are designed to transfer the economic risk of investment away from the securityholder and to a third party shortly after that securityholder acquires the security. Due to these concerns, the SEC proposed to add a new paragraph to Rule 144 that would toll the holding period for restricted securities of reporting companies while an affiliate or non-affiliate is engaged in certain hedging transactions. This proposal met with a substantial level of opposition, with commentators noting, among other things, the significant operational and compliance difficulties that would arise from attempting to track (a) securities subject to hedging transactions in a DTC environment or other environment where securities are fungible and positions are netted or (b) hedged securities positions that change daily or more frequently at certain financial institutions.

2. Rationale for Not Adopting "Tolling Provisions" for Hedging Transactions

Reacting to the strong public criticism of the proposal regarding "tolling provisions" for hedging transactions, the SEC was persuaded that these provisions would unduly complicate Rule 144 and that there was not strong evidence that hedging activity resulted in abuses in the context of Rule 144. Consequently, the SEC did not adopt these provisions. The SEC will continue to monitor hedging activities of holders of restricted securities and, if necessary, will revisit this issue.

D. Revisions to Rule 145: "Presumptive Underwriter" Provisions

Rule 145 provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations, or transfers of assets that are subject to shareholder vote, constitute sales of these securities. Rule 145(c) and Rule 145(d) are known as the "presumptive underwriter" provisions. Specifically, Rule 145(c) deems a person who is a party to these transactions (other than the issuer, or any person who is an affiliate of the issuer when the transaction is submitted for vote or consent) and who publicly offers or sells securities of the issuer acquired in connection with the transaction to be an "underwriter" within the meaning of Section 2(11) of the Securities Act. Rule 145 (d) sets forth the restrictions on the resale of these securities by persons and parties deemed to be underwriters. The practical effect of these rules is to decrease the liquidity of securities held by securityholders of parties that have been subject to merger transactions.

The SEC originally proposed to eliminate the "presumptive underwriter" provisions in its 1997 proposing release. In the June 2007 proposing release, the SEC re-affirmed its belief that the Rule 145 presumptive underwriting provisions were unnecessary. However, based on abusive sales of securities that have resulted from business combinations involving shell companies, the SEC still feels it necessary to apply the presumptive underwriter provision to shell companies, their affiliates, and their promoters. Accordingly, the new rules eliminate the presumed underwriter status provision in Rule 145(c), except with regard to transactions involving shell companies.

Part II – Smaller Reporting Company Regulatory Relief and Simplification Provisions

In a July 2007 proposing release, the SEC set forth its proposals to extend the benefits of its optional disclosure reporting requirements for smaller companies to a larger group of companies.

A. Replacement of "Small Business Issuer" Category with "Smaller Reporting Company"

1. Background

Currently, the term "small business issuers" refers to companies with both a public equity float and annual revenues of less than $25 million. "Non-accelerated filers" (companies with a public equity float of less than $75 million that do not qualify as "large accelerated filers" or "accelerated filers" under Exchange Act Rule 12b-2) have a public equity float of less than $75 million. According to the SEC, of the approximately 12,000 companies that filed annual reports under the Exchange Act in 2006, approximately 4,000 of these companies had a public equity float of less than $25 million, and approximately 5,000 had a public equity float of less than $75 million. In its July 2007 proposing release, the SEC proposed replacing the term "small business issuer" with the term "smaller reporting company" in Securities Act Rule 405 and Exchange Act Rule 12b-2, and inserting the new definition of this term in a new Item 10(f) of Regulation S-K.

2. New "Smaller Reporting Company" Definition; Combination of Two Groups of Scaled Requirements

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The new term "smaller reporting company" refers to companies that are not investment companies or asset-backed issuers, and have a public equity float of $75 million or less. For companies that do not have a public equity float as defined, or are unable to calculate this item (for example, because the company had no significant public common equity outstanding or no market price for its common equity), under the new rules, these companies would be eligible to use the scaled disclosure if their annual revenues were less than $50 million during their most recently completed fiscal year, and if their audited financials available on the filing date establish whether they qualify as a smaller reporting company. The determination of whether an issuer is a smaller reporting company is one that will span an entire fiscal year, based on information for that issuer contained in a Form 10-Q or in its initial registration statement, whichever is first to be filed with the SEC in a given year. As a result, the new term "smaller reporting company" will include two formerly separate groups – "small business issuers" (companies currently eligible to use the Regulation S-B disclosure requirements) and most non-accelerated filers.

Notably, the SEC did not adopt its "inflation indexing" proposal, which would have adjusted the $75 million and $50 million ceilings every five years to account for inflation. However, John White, director of the SEC's Division of Corporation Finance, indicated that the SEC is currently undertaking a larger project to examine indexing across a wider range of existing rules – a project that will also include examining the definitions of large accelerated filers, accelerated filers, and non-accelerated filers.

The "smaller reporting company" definition may be beneficial for a company in two key respects. First, this category enables a much larger group of companies to fall under its umbrella and benefit from the scaled disclosure and reporting requirements. Second, foreign private issuers that satisfy the criteria will be able to qualify as "smaller reporting companies." These companies could, therefore, have the choice of taking advantage of the scaled standards for smaller reporting companies, or providing disclosure based on the requirements of the SEC's forms for foreign private issuers.

B. Twelve Non-Financial Scaled Disclosure Item Requirements from Regulation S-B Are Merged into Regulation S-K

1. Background

Regulation S-B, which is currently available only to U.S. and Canadian issuers, was designed to provide small business issuers with a single source for their SEC disclosure requirements. The SEC's objectives in adopting a new disclosure system for smaller companies were principally to reduce compliance costs, while maintaining adequate investor protection.

2. Integration of Substantive Provisions of Regulation S-B into Regulation S-K

The new rules integrate twelve substantive scaled disclosure items into Regulation S-K that describe a smaller reporting company's business. Among the advantages of this integration is that filings under Regulation S-K may now be used more appropriately as precedent for both small and large companies. Also, by combining two separate, but largely similar, disclosure systems under current Regulation S-B and Regulation S-K, the new rules should have the practical effect of substantially streamlining and administratively simplifying the reporting rules for the reporting company, its attorneys, and the SEC staff.

C. Addition of a New Item 310 (Financial Statements of Smaller Reporting Companies) to Regulation S-K

1. Background

In the July 2007 proposing release, the SEC explains that one of the most important provisions of Regulation S-B is Item 310, which governs the form, content and preparation of financial statements for companies that provide disclosure under Regulation S-B. Currently, the requirements in Item 310 are less detailed that those that appear in Regulation S-X, the regulation that governs the financial statements of most public companies that do not rely on Regulation S-B. The July 2007 proposing release further indicates that Item 310 constitutes one of the most significant examples in Regulation S-B of scaling for smaller companies because it bases the requirements for form, content and preparation of financial statements solely on generally accepted accounting principles ("GAAP"), as opposed to the requirements of Regulation S-X. Also, while Regulation S-X requires an audited

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balance sheet for the last two fiscal years and audited statements of income, cash flows and changes in stockholders' equity for each of the last three fiscal years, Item 310 allows smaller companies to merely provide an audited balance sheet for the latest fiscal year, and to provide audited statements of income cash flows and changes in stockholder's equity for each of the latest two fiscal years.

2. Requirements of New Item 310

There are several substantive changes that will distinguish the new Item 310 from the current Item 310, as follows. First, because "smaller reporting companies" can include all foreign companies, under new Item 310, foreign issuers who elect to use Item 310 will be required to file U.S. GAAP financial statements with the SEC. For this reason, a small foreign issuer will need to weigh the benefits of filing on the forms for a "smaller reporting company" (rather than on the SEC's forms for foreign private issuers) against the burdens of having to prepare U.S. GAAP financials. Second, under the new rules, "smaller reporting companies" will need to provide two years – rather than one year – of audited balance sheet data in annual reports and registration statements. Consequently, one of the key benefits of smaller issuer reporting will be removed under the new rules.

D. Integration of Individual Regulation S-B Disclosure Provisions into Regulation S-K; "A La Carte" Compliance Option

1. Background

In the July 2007 proposing release, the SEC proposed to integrate individual Regulation S-B disclosure items (other than Item 310, as discussed above) into Regulation S-K. To accomplish this, the SEC proposed adding a new paragraph to each relevant item of Regulation S-K that will contain separate disclosure standards for smaller reporting companies. The SEC also proposed that each new paragraph have a heading "Smaller Reporting Companies" for ease of reference.

2. "A La Carte" Compliance Election

The new rules will allow each smaller reporting company to select on an item-by-item, or "a la carte" basis, whether it will comply with the new scaled disclosure requirements in Regulation S-K for smaller reporting companies, or whether it will comply with the more rigorous disclosure requirements in Regulation S-K that are used for other companies. These new rules will give each smaller reporting company both the flexibility to determine at its option whether it takes advantage of one, some or all of Regulation S-K's new scaled disclosure requirements, and the ability to tailor the proper balance of disclosure for its investors.

E. Elimination of Current "SB" Forms

1. Background

To assist small business issuers in their transition from being a previously non-reporting company to becoming a reporting company under the Exchange Act, the SEC developed a transitional registration statement, Form SB-1, and an annual report, Form 10-KSB, for these companies. However, over time, the number of companies that used these forms substantially declined. Because of the infrequent use of the transitional disclosure option, the SEC proposed eliminating this option. Moreover, the SEC proposed eliminating all other "SB" Forms. The SEC's rationale was that integrating the disclosure standards of Regulation S-B into Regulation S-K would mitigate the apparent lack of market acceptance associated with smaller filers.

2. Elimination of Forms SB-1, Form 10-KSB, Form 10-QSB, Form 10-SB, and Form SB-2

When the new rules are implemented, smaller reporting companies will no longer use Form SB-1 or Form 10-KSB. Instead, these companies will use Form S-1 and Form 10-K. There will be a phase-out period for current small business issuers transitioning to smaller reporting companies. As a practical matter, the elimination of all other "SB" Forms likely will result in regulatory simplification by having only one set of disclosure requirements, and is expected to make smaller reporting company filers more "mainstream" through their integration into the Regulation S-K framework.

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Part III – Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Exchange Act

A. Background

For many years, private, non-reporting issuers have used compensatory stock options (stock options issued to employees, directors, consultants and advisors) as non-cash compensation to attract, motivate and retain employees. Since 1990, certain private, non-reporting companies have granted compensatory employee stock options to 500 or more people. Currently, under Section 12(g) of the Exchange Act, companies with 500 or more holders of record of a class of equity securities and assets in excess of $10 million at the end of its most recently ended fiscal year must register that class of securities with the SEC, unless there is an available exemption from registration. Although there is an exemption under Section 12(g) for interests in other employee compensation plans involving securities, there is no exemption for compensatory employee stock options. Consequently, numerous private non-reporting companies that issued compensatory stock options have sought registration relief from the SEC's Division of Corporation Finance. In the past, when certain specified conditions were present, the SEC issued no action letters to provide these companies with the requested relief.

In a July 2007 proposing release, the SEC proposed two exemptions from Exchange Act Rule 12h-1 (which currently lists exemptions from the provisions of Section 12(g) for interests in employee stock bonus, stock purchase, or similar plans) to provide Section 12(g) registration relief to issuers of compensatory employee stock options. The first exemption was intended to provide non-Exchange Act reporting companies with certainty that their compensation decisions with respect to compensatory employee stock options issued under stock option plans would not subject them to Exchange Act reporting and registration requirements prior to the time they became public companies. The second exemption was intended to provide Exchange Act reporting companies with registration relief for only the options (and not the equity securities underlying those options) issued under a stock option plan, when (a) the class of equity securities underlying those options has already been registered under Exchange Act Section 12 and (b) the class of persons eligible to receive or hold the options is limited appropriately.

B. Adoption of the Two Proposed Exemptions Relating to Compensatory Employee Stock Options

Determining that the existing statutory provisions and rules provide holders of employee stock options with appropriate protections under federal securities laws, the SEC adopted two new exemptions to Rule 12h-1, as follows:

- private non-reporting companies will be exempt from Section 12(g) registration for compensatory employee stock options issued under employee stock option plans; and
- companies that are reporting companies under Section 13 or Section 15(d) of the Exchange Act will be exempt from Section 12(g) registration for compensatory employee stock options.

These new exemptions will benefit private companies by preventing them from becoming subject to the Exchange Act's reporting requirements as a result of their granting equity rewards to their employees in the form of employee stock options. Public companies will also benefit from these new exemptions, as they will have enhanced certainty that they need not register their stock options once they have registered the underlying class of equity securities. These new exemptions will also reduce the SEC's administrative burden, as they will have the practical effect of streamlining and reducing the reporting process for applicable companies.

* * *

Effectiveness of New Amendments

The new rules noted above will become effective at the following different times:

- the amendments of Rule 144 and Rule 145 will become effective 60 days following their publication in the Federal Register;
- the amendments with respect to smaller reporting companies will become effective 30 days

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after their publication in the Federal Register; and

- the amendments exempting compensatory employee stock options from registration will become effective upon their publication in the Federal Register.

As of the date of this client alert, the SEC has not yet published the complete text of the new rules. The SEC plans to post adopting releases containing the full text of the new rules on the SEC website as soon as possible.

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