

Bigger Is Smaller: SEC Amends Its Definition of “Smaller Reporting Company,” Making Related Disclosure Relief Available to More Companies

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On June 28, 2018, the Securities and Exchange Commission (the “SEC”) adopted amendments¹ to the definition of “smaller reporting company” (“SRC”) as used in the SEC’s rules and regulations.² The amendments, which will become effective on September 10, 2018, are largely consistent with the definitional amendments proposed by the SEC in June 2016. The amendments are intended to increase the number of public companies that are able to take advantage of scaled disclosure options applicable to SRCs in order to reduce regulatory compliance costs for those companies and also to promote capital formation in general.

Background

A public company that is an SRC may elect to selectively comply with certain reduced disclosure obligations.³ SRCs may elect to take advantage of any number, including all or none, of the relief provisions on an à la carte basis. Attached as Appendix A is a summary of the disclosure relief options available to SRCs.⁴ The disclosure relief options available to SRCs were not amended in any respect.

In addition to the applicable disclosure relief options, SRCs also may benefit from certain transitional relief when new disclosure obligations are adopted. For instance, the SEC delayed the application of the say-on-pay and say-on-frequency stockholder vote requirements to SRCs for two years when those requirements were adopted in 2011. SRCs also have been exempted from certain other disclosure obligations, such as under the SEC’s CEO pay ratio disclosure rules.

Amended Definition of “Smaller Reporting Company”

¹ The full text of the SEC’s adopting release setting forth these amendments (the “Adopting Release”) is available at: <https://www.sec.gov/rules/final/2018/33-10513.pdf>.

² The term “smaller reporting company” is defined in Securities Act Rule 405, Exchange Act Rule 12b-2 and Item 10(f) of Regulation S-K. The three definitions are substantively identical.

³ Where a disclosure requirement applicable to SRCs is more stringent than the corresponding requirement for non-SRCs, SRCs must comply with the more stringent standard. The only instance in which there is a more stringent disclosure requirement applicable to SRCs is under Item 404 of Regulation S-K. Under Item 404, which relates to related party transaction disclosures, (i) the applicable threshold for SRCs is the lesser of \$120,000 or 1% of the average of the company’s total assets at year-end for the two most recently completed fiscal years, not a flat \$120,000 threshold; (ii) SRCs are required to provide additional information regarding parent entities, promoters, and certain control persons; (iii) SRCs must provide information regarding material underwriting discounts and commissions where any of its related persons was or is to be either (a) a principal underwriter or (b) a controlling person or member of a firm that was or is going to be a principal underwriter; and (iv) SRCs must provide an additional year of Item 404 disclosure in filings other than Securities Act registration statements.

⁴ In addition to the relief provisions set forth in Appendix A, an SRC using Form S-1 also benefits from being able to incorporate by reference information filed prior and subsequent to the effectiveness of the registration statement if it meets the eligibility requirements in General Instruction VII of Form S-1, whereas non-SRCs using Form S-1 may not incorporate by reference information filed subsequent to the effectiveness of the registration statement.

Under the amended definition, an SRC is a registrant that (i) is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not an SRC and (ii) satisfies either a revised public float test (the “Public Float Test”) or a test that now is based on both revenue and public float (the “Revenue Test”).

Public Float Test

	<u>Prior Definition</u>	<u>Amended Definition</u>
Public float threshold	\$75 million	\$250 million
Threshold after failing to qualify	\$50 million	\$200 million

A registrant qualifies under the Public Float Test if its public float is less than \$250 million. How a registrant’s public float is calculated depends on whether it already is a SEC reporting company or it is filing its initial registration statement under the Securities Act of 1933, as amended (the “Securities Act”).

- ***Existing SEC reporting company.*** The public float is calculated as of the last business day of the registrant’s most recently completed second fiscal quarter as follows:

$$\begin{array}{l} \text{Aggregate worldwide number of} \\ \text{shares of the registrant’s voting and} \\ \text{nonvoting common equity held by} \\ \text{nonaffiliates on that date} \end{array} \times \begin{array}{l} \text{Price at which the common equity} \\ \text{was last sold, or the average of the} \\ \text{bid and asked prices of the common} \\ \text{equity, in the principal market for} \\ \text{the common equity on that date} \end{array}$$

- ***Registrant filing its initial registration statement under the Securities Act.*** The public float is calculated as of a date within 30 days of the date of the filing of the registration statement as follows:

$$\begin{array}{l} \text{Aggregate worldwide number of} \\ \text{shares of its voting and nonvoting} \\ \text{common equity held by} \\ \text{nonaffiliates before the registration} \\ \qquad \qquad \qquad + \\ \text{Number of shares included in the} \\ \text{registration statement} \end{array} \times \begin{array}{l} \text{The estimated public offering price} \\ \text{of the shares} \end{array}$$

Once a registrant fails to qualify as an SRC based on the Public Float Test, the registrant cannot again become an SRC based on the Public Float Test unless its public float is less than \$200 million as of the relevant measurement date. The lower threshold is designed to prevent instances in which a company frequently moves in and out of SRC qualification based on relatively small year-to-year shifts in public float.

The Adopting Release indicates that 2,072 of the 7,395 registrants that filed a Form 10-K in 2016, or 28.0%, reported having a public float of less than \$75 million. By way of

comparison, 2,851 of those registrants, or 38.6%, reported a public float of less than \$250 million. Therefore, had the amended definition of SRC then been in effect, 779 additional companies may have been eligible for SRC relief based on the Public Float Test.

	Revenue Test	
	Prior Definition	Amended Definition
Annual Revenue threshold	Less than \$50 million and no public float	Less than \$100 million and public float of less than \$700 million
Threshold after failing to qualify	Less than \$40 million and no public float	Less than \$80 million of revenue or less than \$560 million of public float, depending on the criteria which the company previously failed to qualify.

The Revenue Test allows a registrant with public float of less than \$700 million to qualify as an SRC under the Revenue Test if it also has less than \$100 million of annual revenue.⁵ For purposes of the Revenue Test, annual revenue is the revenue for the company's most recently completed fiscal year for which audited financial statements are available, and public float is calculated in the same manner as described above for purposes of the Public Float Test.

Once a registrant fails to qualify as an SRC based on the Revenue Test solely because it had annual revenue in excess of \$100 million, it must have annual revenue of less than \$80 million while also having public float of less than \$700 million in order to satisfy the Revenue Test. If a registrant fails the Revenue Test solely because it exceeds the \$700 million public float threshold, the registrant will be unqualified unless and until it satisfies the lower public float threshold of \$560 million while also having less than \$100 million in annual revenue. If a registrant fails to satisfy the Revenue Test because it exceeds both \$100 million in annual revenue and \$700 million in public float, it must have both annual revenue of less than \$80 million and public float of less than \$560 million in order to satisfy the Revenue Test again. Like with the Public Float Test, the lower threshold is designed to prevent instances in which a company frequently moves in and out of SRC qualification based on relatively small year-to-year shifts in annual revenue.

The Adopting Release states that 568 of the 7,395 registrants that filed a Form 10-K in 2016, or 7.7%, reported having no public float and less than \$50 million in annual revenue. By way of comparison, 26 of those registrants, or 0.4%, reported no public float and annual revenue of more than \$50 million but less than \$100 million. Further, 161 of those registrants, or 2.2%, had \$250 million or more but less than \$700 million of public float and less than \$100 million in

⁵ A registrant with less than \$250 million of public float would satisfy the Public Float Test regardless of the amount of its annual revenue.

annual revenue. Therefore, had the amended definition of SRC then been in effect, 187 additional companies may have been eligible for SRC relief based on the Revenue Test.

Initial SRC Determination Under the Amended Definition

A registrant will qualify as an SRC for its first fiscal year ending after September 10, 2018, if it meets the Public Float Test or the Revenue Test as of the relevant measurement date, without considering the lower thresholds for registrants previously not qualifying as SRCs. For example, a registrant with a September 30 fiscal year-end that previously had not qualified as an SRC but had public float of \$220 million as of March 30, 2018, the last business day of its most recently completed second fiscal quarter, would qualify as an SRC under the Public Float Test for its fiscal year ending September 30, 2018.

Related Amendment to Rule 3-05(b)(2)(iv) of Regulation S-X

Rule 3-05 of Regulation S-X sets forth requirements for the provision of financial statements of businesses acquired or to be acquired in certain Securities Act registration statements and Form 8-K filings. Rule 3-05(b)(2)(iv) has allowed certain registrants otherwise required to provide three years of audited financial statements of businesses acquired or to be acquired to omit financial statements for the earliest of the three fiscal years if the net revenue of the business was less than \$50 million in its most recent fiscal year. The SEC established the \$50 million net revenue threshold in Rule 3-05(b)(2)(iv) at the same time it initially adopted the SRC concept and intended to tie the \$50 million threshold in Rule 3-05(b)(2)(iv) to the threshold in the Revenue Test. As a result, the SEC correspondingly has amended Rule 3-05(b)(2)(iv) to increase its \$50 million net revenue threshold to \$100 million.

Other Related Amendments

The SEC also adopted certain amendments to the definitions of “accelerated filer”⁶ and “large accelerated filer”⁷ contained in Exchange Act Rule 12b-2. As amended, those definitions no longer will exclude registrants that are eligible to use the SRC relief provisions. This will result in some SRCs exceeding the public float thresholds for satisfaction of the accelerated filer definition (e.g., SRCs with public float between \$75 million and \$250 million) and, in a smaller

⁶ Rule 12b-2 has defined “accelerated filer” as a registrant after it first meets the following conditions as of the end of its fiscal year: (i) the registrant had an aggregate worldwide market value of the voting and nonvoting common equity held by its nonaffiliates of \$75 million or more, but less than \$700 million, as of the last business day of the registrant’s most recently completed second fiscal quarter; (ii) the registrant has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; (iii) the registrant has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (iv) the registrant is not eligible to use the requirements for SRCs under Regulation S-K for its periodic reports.

⁷ Rule 12b-2 has defined “large accelerated filer” to be a registrant after it first meets the following conditions as of the end of its fiscal year: (i) the registrant had an aggregate worldwide market value of the voting and nonvoting common equity held by its nonaffiliates of \$700 million or more, as of the last business day of the registrant’s most recently completed second fiscal quarter; (ii) the registrant has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; (iii) the registrant has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (iv) the registrant is not eligible to use the requirements for SRCs under Regulation S-K for its periodic reports.

number of cases, the large accelerated filer definition.⁸ The implications of being an accelerated filer or a large accelerated filer include more compressed timing for filing Form 10-Ks and Form 10-Qs and needing to have the registrant's auditor provide an attestation report on internal control over financial reporting under Sarbanes-Oxley Act Section 404(b).

The SEC adopted further conforming amendments to the cover pages of Securities Act Forms S-1, S-3, S-4, S-8 and S-11 and Exchange Act Forms 10, 10-Q and 10-K to remove the parenthetical next to the "non-accelerated filer" definition. That parenthetical has stated "(Do not check if a smaller reporting company)." After September 10, 2018, registrants will check all applicable boxes on those cover pages.

While the SEC did not amend the public float thresholds for qualifying as an accelerated filer or a large accelerated filer, the SEC's Chairman directed the SEC staff to provide recommendations to the SEC for suggested further amendments in order to reduce the number of registrants that would qualify as accelerated filers. The SEC Chairman instructed the staff to consider the historical and current relationship between the SRC definition and the accelerated filer definition, among other things.

What Companies Should Do Now

There are several things that public companies should do now in light of the amendments set forth in the Adopting Release. Our recommended action items in the short term include the following:

- Companies should calculate their public floats promptly after the end of their second fiscal quarters.
- A company that will qualify as an SRC, or thinks that it might qualify as an SRC as of its next measurement date, should evaluate the scaled disclosure options available to an SRC and assess which, if any, of such options are appealing to it.
- In assessing the SRC relief provisions, a company should consider other factors that may lead it to decline to use one or more of the relief provisions. Common reasons why an SRC elects not to utilize one or more relief provisions include the following:
 - Investors, analysts, or other important parties may have a particular reason to value certain information that otherwise would be excluded, causing investor relations or similar concerns if the expanded disclosures are not made.
 - If the company voluntarily provided the additional information in the past although it was an SRC, or it previously had to provide the additional disclosure because the company was not an SRC, there may be investors, analysts or other important parties that have an affirmative expectation that

⁸ An SRC also could qualify as a large accelerated filer if (i) it previously qualified as a large accelerated filer because its public float was \$700 million or more; (ii) its revenue for its most recent fiscal year was less than \$100 million; and (iii) its public float as of the end of its most recent second fiscal quarter was less than \$560 million but not less than \$500 million, meaning that it is not eligible to leave its large accelerated filer status.

they will continue to have access to the same information year-to-year, regardless of the company's eligibility to use SRC relief provisions.

- Particularly, where the company previously did not qualify as an SRC, the company may have disclosure controls and procedures in place such that continuing to provide the additional information involves minimal incremental resources.
- A newly qualifying SRC may believe that it likely will transition out of SRC status at its next determination date and that it makes sense to maintain its prior disclosure patterns rather than going back-and-forth by using SRC relief provisions.
- Likewise, a growing SRC may believe that it will not qualify as an SRC at its next measurement date and that it is advantageous to make disclosures voluntarily as if it is not an SRC in order to establish disclosure continuity going forward.
- Under its circumstances, the company may find it impossible to view its periodic report as being not misleading in the absence of expanded information.⁹
- There may be strategic benefit in declining to utilize a particular SRC relief provision (e.g., the liability benefits associated with having risk factors in the Form 10-K).
- If a company has completed or is considering a material acquisition that otherwise will require it to provide three years of audited financial statements of a business acquired or to be acquired, the company should determine whether it may take advantage of relief under the amended Rule 3-05(b)(2)(iv) because the net revenue of the business acquired or to be acquired was less than \$100 million in its most recent fiscal year.

⁹ Like all registrants, SRCs will remain liable for disclosures and, in addition to disclosures expressly required to be provided, will continue to be required to provide such further material information, if any, as may be necessary to make any required statements, in the light of the circumstances under which they are made, not misleading. See Securities Act Rule 408 and Exchange Act Rule 12b-20.

APPENDIX A

Item	Scaled Disclosure Accommodations for SRCs
	Regulation S-K
101 — Description of Business (Item 1 of Form 10-K)	Describe the general development of the business of the registrant during the past three years, rather than five years. The business development description requirements also are less detailed as compared to the requirements for non-SRCs.
201 — Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters (Item 5 of Form 10-K)	Stock performance graph is 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 years of MD&A comparison rather than three-year comparison. Two-year discussion of impact of inflation and changes in prices rather than three-year discussion. Tabular disclosure of contractual obligations not required.
305 — Quantitative and Qualitative Disclosures About Market Risk	Not required.
402 — Executive Compensation	Three named executive officers in most cases, rather than five named executive officers in most cases. Two years of summary compensation table information rather than three years. The following are not required: <ul style="list-style-type: none">• 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; and• CEO pay ratio disclosures.

Item	Scaled Disclosure Accommodations for SRCs
	Regulation S-K
404 — Transactions with Related Persons, Promoters and Certain Control Persons	<p>Description of policies/procedures for the review, approval or ratification of related party transactions is not required.</p> <p>See footnote 3 in this Alert for a description of certain <i>expanded</i> disclosure requirements under Item 404 applicable to smaller reporting companies.</p>
407 — Corporate Governance	<p>Audit committee financial expert disclosure not required in the first annual report after the initial registration statement under the Securities Act or Exchange Act becomes effective.</p> <p>Compensation committee interlocks and insider participation disclosure is not required.</p> <p>Compensation committee report is not required.</p>
503 — Prospectus Summary, Risk Factors and Ratio of Earnings to Fixed Charges	<p>No ratio of earnings to fixed charges disclosure is required.</p> <p>No risk factors are required in Exchange Act filings.</p>
601 — Exhibits	<p>Statements regarding computation of ratios are not required.</p>
	Regulation S-X
8-02 — Annual Financial Statements	<p>Two years of income statements rather than three years.</p> <p>Two years of cash flow statements rather than three years.</p> <p>Two years of changes in stockholders' equity statements rather than three years.</p>
8-03 — Interim Financial Statements	<p>Certain historical financial data can be provided in lieu of separate historical financial statements of equity investees.</p>
8-04 — Financial Statements of Businesses Acquired or to Be Acquired	<p>Maximum of two years of acquiree financial statements rather than maximum of three years.</p>
8-05 — Pro forma Financial Information	<p>Fewer circumstances in which pro forma financial information is required.</p>
8-06 — Real Estate Operations Acquired or to Be Acquired	<p>Maximum of two years of financial statements for acquisitions of properties from related parties rather than three years.</p>
8-08 — Age of Financial Statements	<p>Less stringent age of financial statements requirements.</p>