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SEC Expands Eligibility for Smaller Reporting Company Status

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At the end of June, the SEC voted unanimously to amend the definition of "smaller reporting company," or SRC, allowing more companies to take advantage of the scaled disclosures permitted, on an item-by-item basis, for companies that meet the definition. The **amendments** raise the SRC cap from "less than $75 million" in public float to "less than $250 million" and also include as SRCs companies with less than $100 million in annual revenues if they also have either no public float *or, in a change from the proposal*, a public float that is less than $700 million. The amendments were intended to promote capital formation and to reduce compliance costs for small public companies, while maintaining, "appropriate investor protections." The amendments become effective on September 10, 2018. As noted in the adopting release, SEC Chair Jay Clayton has directed the staff to study and make recommendations regarding possible modifications to the definition of "accelerated filer," which, if adopted, would not only extend the periodic report filing deadlines for many smaller companies, but, more significantly, enable more companies to avoid a SOX 404(b) auditor's internal control attestation.

For two years prior to its adoption, the proposal had been marinating in controversy – not as a result of the changes it proposed but rather a result of the changes it didn't. While all of the SEC Commissioners unanimously voted in favor of adoption, all (except Chair Clayton) greeted the final rules with surprising indifference, letting it be known that they viewed the amendments to the definition of "smaller reporting company" to be generally unobjectionable – and largely inconsequential. However, the Chair's direction to the staff to recommend possible modifications to the definition of "accelerated filer" was concerning on all sides, albeit for different reasons. To Commissioners Michael Piwowar and Hester Peirce, the failure to provide relief from the auditor attestation requirement as part of the current rulemaking package relegated the amendments to the SRC definition to the status of a mere technical change or a prelude to more impactful rulemaking – one that might save some compliance costs but would not affect capital formation. But to Commissioners Kara Stein and Robert Jackson, Jr., the prospect of future changes to the rules to allow more companies to avoid auditor attestations, viewed as a critical investor protection, was itself disquieting.

Current rules

Under current rules, a company qualifies as an SRC if it has either (1) less than $75 million in public float (*i.e.,* voting and non-voting common equity held by non-affiliates) as of the last business day of its most recently completed second fiscal quarter or (2) no public float (*e.g.*, because it has no public equity outstanding or no market price exists for its equity) and annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available. SRC status is determined annually.

New amendments

Initial qualification as an SRC. Under the "public float test" in the new definition, the cap to qualify as an SRC will be raised to "less than $250 million" in public float. In addition, under the "revenue test," a company with less than $700 million in public float (or no public float) could qualify as an SRC if it had annual revenues of less than $100 million during its most recently completed fiscal year. (A company that qualifies as an SRC under the public float test would qualify regardless of its revenues.) The new component of the revenue test was added to allow highly valued pre-revenue companies, such as a number of biotechs, to continue to focus on innovation and benefit from the cost savings of the scaled disclosure accommodations. For purposes of the first fiscal year ending after effectiveness of the amendments, a company can qualify as an SRC under one of these revised "initial qualification" caps as of the date it is required to measure its public float or revenues, even if the company did not previously qualify as an SRC.

Initial SRC Caps		
Criteria	**Current Definition**	**Revised Definition**
Public Float	Public float of less than $75 million	Public float of less than $250 million
Revenues	Less than $50 million of annual revenues and no public float	Less than $100 million of annual revenues and public float of less than $700 million (including no public float)

Qualifying as an SRC after exceeding initial caps. If, however, the company does not qualify as an SRC under the initial qualification caps above (or fails to qualify thereafter as of an annual determination), it will remain unqualified until it meets other lower caps set at 80% of the initial qualification caps: under the public float test, until it determines that its public float is less than $200 million or, under the revenue test, until it has annual revenues of less than $80 million during its previous fiscal year, if it previously had $100 million or more of annual revenues, or less than $560 million of public float, if it previously had $700 million or more of public float, or both, if both are exceeded. That is, the company needs to qualify under the relevant lower cap with respect to the cap or caps it previously exceeded. This structure is designed to avoid situations in which companies enter and exit SRC status due to small fluctuations in their public float or revenues.

Subsequent SRC Caps		
Criteria	**Current Definition**	**Revised Definition**
Public Float	Public float of less than $50 million	Public float of less than $200 million, if it previously had $250 million or more of public float
Revenues	Less than $40 million of annual revenues and no public float	Less than $80 million of annual revenues, if it previously had $100 million or more of annual revenues; and Less than $560 million of public float, if it previously had $700 million or more of public float.

Acquired businesses. In another change from the proposal, the final rules also include amendments related to financial statements of acquired businesses. The final rules amend Rule 3-05(b)(2)(iv) of Regulation S-X to increase the net revenue cap from $50 million to $100 million, allowing companies to omit financial statements of businesses acquired or to be acquired for the earliest of the three fiscal years otherwise required by Rule 3-05 if the net revenues of that acquired business are less than $100 million.

Conforming amendments. There are also conforming amendments to the definition in Rule 12b-2 of "accelerated filer" and "large accelerated filer" to provide that qualifying as an SRC will no longer automatically make a company a non-accelerated filer. That is, even though they might qualify as SRCs, companies with $75 million or more of public float would remain subject to the "accelerated filer" requirements, including the accelerated timing of filing of periodic reports and the requirement to provide a SOX 404(b) auditor's internal control attestation.

In addition, related technical amendments were made to Securities Act Forms S-1, S-3, S-4, S-8, and S-11 and Exchange Act Forms 10, 10-Q and 10-K. These amendments modify the cover page of the specified forms to remove the parenthetical next to the "non-accelerated filer" definition that states "(Do not check if a smaller reporting company)." After these amendments, a company should check all applicable boxes on the cover page addressing, among other things, non-accelerated, accelerated, and large accelerated filer status, SRC status, and emerging growth company, or EGC, status.

Scaled disclosure. The new amendments do not change any of the scaled disclosure requirements, and SRCs continue to be allowed to comply with the SEC's disclosures requirements on a scaled item-by-item basis. SRCs may, for example, omit several of the otherwise required compensation tables, the Compensation Discussion and Analysis, or CD&A, and the pay-ratio disclosure. (See Appendix A to this Alert for the SEC's tables of "Scaled Disclosure Accommodations" in Regulations S-K and S-X and "Observations and commentary" below for a discussion of compensation disclosure considerations.) SRCs can also use Form S-1 registration statements to "forward incorporate" subsequently filed information if they meet the eligibility requirements specified in the Form's instructions. In addition, SRCs may be slow-walked into new requirements with extended phase-ins, such as in the proposed pay-for-performance disclosure rules. Notably, however, there are some requirements in Regulation S-K Item 404 (transactions with related persons) that are more rigorous, and SRCs *must comply* with those requirements. See the note to the table in Appendix A.

Observations and commentary

- Because SRCs may opt for scaled disclosure on item-by-item basis, many SRCs have – and it's likely that many newly minted SRCs will – decide to comply with some disclosure requirements on a voluntary basis. For example, SRCs are not required to include risk factors in their Exchange Act filings, but because the Private Securities Litigation Reform Act requires that, to obtain PSLRA protection, forward-looking statements must be "accompanied" by cautionary language, many companies will voluntarily elect to provide risk factor disclosures. In some cases, market expectations may drive companies to provide three years of audited financial statements, even though SRCs are required to provide only two.
- Notably, SRCs are not relieved of the obligation to solicit say-on-pay votes. As a result, before deciding whether to opt for scaled compensation disclosure, SRCs should consider the potential effect on say-on-pay votes and director elections. Each SRC – and particularly any company that has just qualified as an SRC and previously included full compensation disclosure in its proxy statement – should consider whether to continue to provide a CD&A, or a similar enhanced discussion of executive compensation, to explain its executive compensation philosophy and practices in an effort to secure favorable votes from institutional shareholders and favorable vote recommendations from the proxy advisory firms. As investors clamor for increased transparency with respect to executive and director compensation, we expect that many newly qualified SRCs will provide additional compensation information in their annual proxy statements beyond the minimum scaled disclosure requirements.
- The change to the SRC definition was recommended in a recent **Treasury report**, as well as by numerous advisory groups, all of which have been clamoring relentlessly for relief from the burdens of disclosure and other regulation for smaller public companies. **Chair Clayton** viewed the new amendments as a step in the direction of facilitating capital formation by recognizing that a "one-size regulatory structure for public companies does not fit all." He did not believe that the scaled disclosure requirements would impair investor protections: these companies, he observed, will continue to have "substantial public disclosure requirements, will remain liable for their required disclosures, as well as any materially misleading statements, and will

continue to be subject to the Division of Corporation Finance's filing review process." Moreover, he noted that these scaled disclosure requirements are "almost always substantially higher" than those applicable to private companies.

- The SEC staff estimated that, under the new definition, 966 additional companies will be eligible for SRC status in the first year, with many concentrated in the pharmaceutical products and banking industries, including "779 companies with a public float of $75 million or more and less than $250 million; 161 companies with a public float of $250 million or more and less than $700 million and revenues of less than $100 million; and 26 companies with no public float and revenues of $50 million or more and less than $100 million." The staff estimated total annual cost savings per newly eligible registrant with a public float around the $75 million cap to be between approximately $100,000 and $300,000. In addition, the staff found that, for most of the newly eligible SRCs under the final rules, scaled disclosures might generate "a modest, but statistically significant, deterioration in the overall quality of information environment and [have] a muted effect on the growth of the registrant's capital investments, investments in R&D, and assets."
- The debate among the Commissioners regarding the new rulemaking mirrored in many ways the debate ongoing in the public sphere about the reasons for the decline in recent years in the number of IPOs and public companies: is the decline attributable primarily to regulatory burden or is it attributable to any of a variety of other reasons, such as the substantial availability of capital in the private markets, the greater maturity expected of IPO candidates, the proliferation of opportunities for liquidity for investors and employees through secondary trading in the private markets, changes to the Exchange Act registration threshold that permit companies to stay private longer or concerns regarding hedge-fund activists that impose short-term pressure for quarterly results.

  At the open meeting at which the new rules were considered, **Commissioner Stein** questioned whether the rule changes would actually drive capital formation, contending that there was no evidence that the "regulatory burden" at which the rule was directed actually discouraged companies from accessing the public markets; what the evidence did support, she maintained, was that investors apply a discount where companies provide reduced disclosure. **Commissioner Jackson** also took issue with the underlying message that cutting red tape was the secret to helping small companies go and stay public. Rather, he contended that there was no evidence in support of that view, indicating further that he was "unprepared to make policy on the basis of that assumption going forward." Instead, the evidence supported the conclusion that the cost of going public was much more significant and that reductions in regulation could increase the cost of capital and make retail investors more wary of investing in small companies. He and his staff, he advised, will be studying the effects of reduced disclosure on fraud and the cost of capital for future policymaking.

  To Commissioners Piwowar and Peirce, however, the problem with this rulemaking was that it did not go far enough in relieving the type of regulatory burden that drove companies away from the public markets. **Commissioner Piwowar** expressed his disappointment that the current rulemaking was not a serious reform oriented toward capital formation, but rather would likely result in only modest cost savings. Had the SEC gone ahead with rule amendments expanding the exemption from SOX 404(b) for more small issuers, the SEC could have appreciably advanced the cause of capital formation. Agreeing with Commissioner Piwowar, **Commissioner Peirce** viewed these changes to the SRC definition as just a "cautious beginning – a welcome prelude to more meaningful future steps, but not on their own likely to make a definitive difference for small companies considering going public."

On the horizon

The adopting release indicates that, not surprisingly, many commenters took the opportunity to recommend that the SEC increase the public float cap in the "accelerated filer" definition commensurate with the cap in the new SRC definition, arguing that the costs associated with the SOX 404(b) auditor's internal control attestation were burdensome and "divert capital from core business needs." Although, notwithstanding the admitted additional regulatory complexity, the SEC elected not to raise the accelerated filer cap at this time, Chair Clayton did direct the staff to formulate recommendations "for possible additional changes to the 'accelerated filer' definition that, if adopted, would have the effect of reducing the number of companies that qualify as accelerated filers in order to promote capital formation by reducing compliance costs for those companies, while maintaining appropriate investor protections."

Observations and commentary

- In 2015, the SEC's Advisory Committee on Small and Emerging Companies recommended that the SEC increase the threshold for "accelerated filers" to include companies with a public float of $250 million or more, but less than $700 million, in large part to relieve more small companies of the obligation to provide an auditor attestation report under SOX 404(b). However, in the 2016 release proposing the change to the SRC definition, **the SEC expressly rejected** that Committee recommendation on the basis of a 2011 SEC staff study, which found

  > "no specific evidence that any potential savings from exempting registrants with public floats between $75 million and $250 million from the auditor attestation provisions of Section 404(b) would justify the loss of investor protections and benefits to registrants from such an exemption. Rather, the staff found that accelerated filers (including those with a public float between $75 million and $250 million) that were subject to the Section 404(b) auditor attestation requirements generally had a lower restatement rate than registrants that were not subject to the requirements. Moreover, the staff found that the population of registrants with public floats between $75 million and $250 million did not have sufficiently unique characteristics that would justify differentiating this population of registrants from other accelerated filers with respect to the Section 404 auditor attestation requirements."

  The proposing release also observed that subsequent academic research on this topic was mixed. As a result, the SEC did not propose to raise the accelerated filer public float cap or to modify the SOX 404(b) requirement as part of that the 2016 proposal, but did request comment on the issue. The Committee's final report in 2017 reiterated its recommendation to amend the "accelerated filer" definition.

- Since the proposal regarding the definition of SRCs was issued in 2016, many critics have trained their sights on SOX 404(b), arguing that requiring controls audits for smaller companies did not make much sense, especially for pre-revenue companies such as many smaller biotechs that had little revenue and few employees. In those cases, the cost of the controls audit would divert capital from other more important uses, such as R&D. In one example cited by a critic, the cost of the controls audit for one small public biotech with fewer than 60 employees and a public float of $85 million added 1% to the company's burn rate. In addition, critics have argued that controls audits did not add much value: in one study, 84% of restatements were not preceded by reports of material weaknesses; that is, they contend, the 404(b) audits failed. Moreover, critics have identified SOX 404(b) as a significant contributor to the type of regulatory overload that some argue has deterred companies from conducting IPOs; the attestation audit was just too time-consuming and expensive for many smaller companies.

  Advocates of SOX 404(b), however, have emphasized that internal controls are the backbone of the financial statements, and some auditors view the attestation as more important than the audit itself. According to **Audit Analytics**, the percentage of adverse internal control auditor attestations has decreased from 15.7% in 2004 to 5.3% in 2015. In its **2015 Financial Restatements Report**, Audit Analytics "found that after the implementation of SOX there was a massive increase in financial restatements that peaked at 1,851 in 2006. That number declined significantly to just 737 in 2015." In addition, it "found that the financial impact on net income has also declined. Restatements of $3 billion to $6 billion were made in each year between 2002 and 2006. Since 2008 only one year had a restatement that has impacted net income by more than $1 billion." Similarly, advocates contend, a GAO study found that companies exempt from controls audits had more restatements, while another study showed that companies that had controls audits had higher valuation premiums and lower cost of debt. Advocates also note that the cost of the attestation audit has declined over time, particularly incremental costs as part of an integrated audit

- While Commissioners Piwowar and Peirce lamented the failure of the current rulemaking to provide relief from the burden of SOX 404(b) for more small companies, Commissioners Stein and Jackson both pointed to the 2011 SEC staff study for support that auditor attestations provided beneficial investor protections, resulting not only in lower rates of financial restatements, but also lower cost of capital as a result of increased investor confidence. Unless Commissioner Jackson saw "robust and reliable economic analysis" supporting "the notion that making changes to our rules under Section 404(b) would serve any part of our mission of investor protection, fair markets, and capital formation," he would "remain extremely concerned about the possibility of any exemptions to those rules."

If you have any questions about this alert, please contact one of your Cooley team members or one of the attorneys identified here.

Appendix A – SEC Tables of Scaled Disclosure Accommodations

Regulation S-K

Item	Scaled Disclosure Accommodation
101 − Description of Business	May satisfy disclosure obligations by describing the development of the registrant's business during the last three years rather than five years. Business development description requirements are less detailed than disclosure requirements for non-SRCs.
201 − Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters	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 rather than three-year comparison. Two year discussion of impact of inflation and changes in prices rather than three years. Tabular disclosure of contractual obligations not required.
305 – Quantitative and Qualitative Disclosures About Market Risk	Not required.

Appendix A – SEC Tables of Scaled Disclosure Accommodations

Regulation S-K

Item	Scaled Disclosure Accommodation
402 – Executive Compensation	Three named executive officers rather than five. Two years of summary compensation table information rather than three. Not required: ▪ 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[1]	Description of policies/procedures for the review, approval or ratification of related party transactions not required.
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	No ratio of earnings to fixed charges disclosure required. No risk factors required in Exchange Act filings.
601 – Exhibits	Statements regarding computation of ratios not required.

Regulation S-X	
Rule	**Scaled Disclosure**
8-02 – Annual Financial Statements	Two years of income statements rather than three years. Two years of cash flow statements rather than three years. Two years of changes in stockholders' equity statements rather than three years.
8-03 – Interim Financial Statements	Permits certain historical financial data in lieu of separate historical financial statements of equity investees.
8-04 – Financial Statements of Businesses Acquired or to Be Acquired	Maximum of two years of acquiree financial statements rather than three years.
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 rather than three years.
8-08 – Age of Financial Statements	Less stringent age of financial statements requirements.

Notes

1. Item 404 also contains the following expanded mandatory disclosure requirements applicable to SRCs: (1) rather than a flat $120,000 disclosure threshold, the threshold is the lesser of $120,000 or 1% of total assets, (2) disclosures are required about underwriting discounts and commissions where a related person is a principal underwriter or a controlling person or member of a firm that was or is going to be a principal underwriter, (3) disclosures are required about the issuer's parent(s) and their basis of control, and (4) an additional year of Item 404 disclosure is required in filings other than registration statements.

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