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Smaller Reporting Companies

Disclosure and Governance Considerations

By Sanjay M. Shirodkar and Kristi Darnell-Weichelt

Over the past few years, considerable time and energy has been spent on providing helpful commentary on the reporting and other obligations associated with mid- and large- sized public companies. This is particularly true since the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). However, one group of companies is frequently overlooked in this commentary: companies that, based on their size, are defined as a "smaller reporting company" (SRC) by the Securities and Exchange Commission (Commission). It is important to note that, based on published results, there are considerably more SRC companies than larger-accelerated or accelerated companies.

In this article, we discuss some of the Commission initiatives leading up to the creation of the SRC category, address some special Commission rules that relate to SRCs, summarize some of the hot-button disclosure issues relating to SRCs that the Commission staff has focused on, explain how some of the Commission rules applicable to SRCs are different from those applicable to larger reporting companies, and review recent rulemaking by the Commission related to the application of the Dodd-Frank Act to SRCs. We also include an annex listing Commission guidance that may be helpful to SRCs.

Commission Initiatives for SRCs

The Commission has historically made special efforts not to subject smaller companies and their investors to unduly burdensome federal securities regulation. For example, as mandated by the Small Business Investment Incentive Act of 1980, the Commission hosts an annual forum that focuses on the capital formation concerns of small businesses. The forum is called the "SEC Government-Business Forum on Small Business Capital Formation." According to the Commission, a major purpose of the forum is to provide a platform for small businesses to highlight perceived unnecessary impediments in the capital-raising process and address whether they can be eliminated or reduced.

The Commission's special concern for smaller companies was, in part, driven by the special role that such corporate entities historically have played as a driver of economic activity, innovation, and job creation in the United States. In March 2005, the Commission chartered an Advisory Committee on Smaller Public Companies (Advisory Committee) and asked the committee to assess the existing regulatory system for smaller companies under the federal securities laws and to recommend changes to that system. Based upon the Advisory Committee's recommendation in 2007, the Commission proposed far-reaching changes to improve federal securities regulations that significantly affect smaller companies and their investors. Final rules were adopted by the Commission in late 2007. The Commission explained that its rule changes had three primary objectives:

- Expanding eligibility for "scaled disclosure" and reporting requirements for smaller companies by making those requirements available to most companies with a public float of less than $75 million.
- Reducing unnecessary complexity by combining the two categories of "small business issuers" and "non-accelerated filers" into one category called "smaller reporting companies."
- Simplifying and improving the disclosure and reporting rules for smaller companies by maintaining the Regulation S-B disclosure requirements for smaller companies by integrating them into the disclosure requirements in Regulation S-K.

The revised rules permitted SRCs to comply with only a subset of the public disclosure requirements applicable to larger companies in their registration statements, periodic reports, and proxy statements, eliminated Regulation S-B, and moved the scaled disclosure requirements to Regulation S-K or the newly created Article 8 of Regulation S-X. Under the revised rules, an SRC has the flexibility to comply with the scaled disclosure requirements on an à la carte basis – meaning that it can either comply with the scaled disclosure and financial reporting requirements made available in Regulation S-K for SRC or the requirements in Regulation S-K that are applicable to larger companies. In other words, an SRC can voluntary report under the more rigorous requirements in Regulation S-K that are applicable to larger companies. SRCs are, however, required to comply with certain SRC item requirements that are more rigorous than the requirements of other companies in Regulation S-K. Foreign companies are permitted to qualify as an SRC if they otherwise qualify and choose to file on domestic company forms and provide financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles.

Qualifying for SRC Status

There are three different categories of companies that may qualify to be an SRC: (1) reporting companies that have a public float at or below the SRC threshold of $75 million; (2) non-reporting companies that are filing a registration statement and have a public float at or below the SRC threshold of $75 million; and (3) reporting or non-reporting companies that do not have a public float and have annual revenues of less than $50 million. A company's public float is calculated by multiplying the price of the company's equity on the last business day of its most recently completed second fiscal quarter, by the aggregate worldwide number of shares of the company's voting and non-voting common equity held by non-affiliates of the company on such date. Each company's public float and revenues are then tested on an annual basis to determine whether its reporting status has changed. For example, if a company's public float or revenues are initially above the SRC threshold, it can still fall within the SRC category in subsequent years if its public float is less than $50 million, or, if it has no public float, its consolidated revenues for the prior fiscal year are less than $40 million. Non-reporting companies that file a registration statement under the Securities Act of 1933, as amended, are required to calculate their public float as of a date within 30 days of filing its registration statement. There is an alternative test for reporting companies or non-reporting companies that do not have a public float: such companies must have annual revenues of $50 million or less in the last fiscal year.

There are specific rules regarding entering and exiting the SRC reporting regime and most companies tend to solicit expert advice on such rules. A larger reporting company that determines it qualifies to be an SRC as of the last business day of its most recently completed second fiscal quarter is permitted to file as a smaller reporting company in its quarterly report for such quarter. SRCs are required to exit the scaled disclosure system the fiscal year after its public float rises above $75 million as of the last business day of its second quarter. In other words, an SRC is required to transition to the larger reporting company system if its public float rises above $75 million as of the last business day of its second quarter.

Hot Button Disclosure Initiatives

The following are some hot button issues relating to SRCs that have been identified by the Commission staff:

Management's Discussion and Analysis (MD&A)

The requirements of a company's MD&A are generally governed by Item 303 of Regulation S-K. The Commission staff has also published some interpretive guidance on MD&A. In addition, many securities law practitioners like to keep abreast of Commission enforcement actions in this arena. The three main aspects of MD&A are: result of operations, liquidity, and disclosure regarding potential upcoming events. The Commission staff has noted that MD&A is designed to provide a narrative explanation of a company's financial statements through the eyes of management, to enhance the overall financial disclosure and provide the context within which financial information should be analyzed, and to provide information about the quality and the potential variability of a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. According to the Commission staff, companies should provide an overview highlighting both financial and non-financial key performance indicators as background and should focus on the factors contributing to fluctuations in operating results from period to period. In the Liquidity section, the Commission staff has noted that a registrant's sources and uses of cash may be an area where disclosure is rapidly evolving for SRCs. The key issues here are how a registrant funds its operations by considering what its significant bills are and how the registrant pays those bills. Additionally, the Commission staff has indicated that SRCs should disclose impairment losses and consider the need for disclosure of "non-impairments" or "non-events" in certain situations.

Reverse Mergers or Back Door Registrations

Reverse mergers, or back door registration transactions generally take the form of a private operating company merging with a public shell and gaining the ability to issue public stock. Over the past few years, a growing number of private companies domiciled in China have sought to access the U.S. capital markets through this method. The Commission staff and the staff of the Public Company Account Oversight Board (PCAOB) have increasingly focused on the qualifications of the auditor in such transactions. It is not uncommon for the Commission staff to issue comments on the ability of a domestic firm to perform fieldwork on the foreign company in light of the distance and language barriers. If a domestic auditing firm is relying on a firm overseas, the Commission staff has regularly inquired about the registration of the foreign firm with the PCAOB. Also, unless the same audit firm audited both the private company and the public shell (or the accounting acquirer), a reverse merger generally results in a change of the audit firm. Careful consideration should be given to the timing and contents of the various filings required in such transactions.

Embedded Conversion Options and Freestanding Warrants

The Commission staff has noted that it is a complicated path to determine the correct accounting treatment of embedded conversion options and freestanding warrants. The key here is to discuss the treatment with qualified accounting personnel and to involve your auditors early in the process. The Commission staff has issued comments related to the recognition and presentation of such instruments, including how derivatives and bifurcated embedded features have been measured.

Smaller Reporting Company Status
The Commission staff has focused on the manner in which a company calculated its public float, the timing of a company's assessment as to whether it qualified as an SRC, and the other transition rules that apply when a company either enters or exits the SRC regime.

Use of Proceeds
Item 504 of Regulation S-K sets forth the requirements for companies to disclose the principal purposes for which the net proceeds of an offering will be used and the approximate amount intended to be used for each purpose. When a company makes its offering on a best efforts basis, it is not unusual for its intended use of proceeds to change depending on the volume sold. The Commission staff frequently requests companies to pick benchmarks for the amount of securities that it may sell, for example, 25%, 50%, 75%, and 100%, and indicate how it will allocate the proceeds at each benchmark.

Differences in Regulation S-K Provisions

When working with SRCs, many practitioners find it somewhat difficult to identify which provisions of Regulation S-K are applicable. We have therefore prepared a brief list which sets forth the items under Regulation S-K that contain scaled disclosure requirements for SRCs, along with a description of the key differences between the requirements applicable to both larger companies and SRCs:

Description of Business (Item 101)
Larger reporting companies are required to describe the key elements of their businesses during the past five years, including lengthy narrative descriptions of their industry segments. Pursuant to paragraph (h) of Item 101, SRCs are required to describe the developments of their business during the last three years, as opposed to the last five years. Additionally, SRCs are permitted to provide less detailed description of their business and are not required to provide financial information about segments.

Market Price, Dividends and Related Stockholder Matters (Item 201)
Pursuant to Instruction 6 to paragraph (e) of Item 201, SRCs are not required to provide a performance graph.

Selected Financial Data (Item 301)
Larger reporting companies are required to provide selected financial data for the past five years. Pursuant to paragraph (c) of Item 301, SRCs are not required to provide the information required by Item 301.

Supplementary Financial Information (Item 302)
SRCs are not required to comply with this item.

Discussion and Analysis of Financial Condition and Results of Operation (Item 303)
Larger reporting companies are required to provide a discussion of the registrant's financial condition, changes in financial condition, and results of operations for the three year period covered by the financial statement, and they are required to use year-to-year comparisons. Pursuant to paragraph (d) of Item 303, if an SRC provides financial information on net sales and revenues and on income from continuing operations for only the two prior years, it can also provide information regarding the impact of inflation and changing prices on the SRC's net sales, revenues and income from continuing operations for the same two year period. SRCs are not required to provide the tabular disclosure of contractual obligation as required by Item 303(a)(5).

Executive Compensation (Item 402)
SRCs are not required to provide the significant compensation discussion and analysis (CD&A) narrative that must be provided by larger companies. An SRC's Summary Compensation Table needs only to provide information for the two prior years (as opposed to the three prior years). However, because there is no CD&A, an SRC must provide some additional narrative to explain the items contained in its Summary Compensation Table and Outstanding Equity Awards at Fiscal Year-End Table. SRCs can also omit from their reports the following tables: Grants of Plan-Based Awards Table, Non-Qualified Deferred Compensation Table, Pension Benefits Table, and Option Exercise and Stock Vested Table. Finally, SRCs are not required to disclose regarding the relationship between compensation and risk.

Transactions with Related Persons, Promoters, and Certain Control Persons (Item 404)
The threshold for related party disclosures by SRCs is lower than is applicable to larger companies (transactions with a value equal to the lesser of $120,000 or one percent of the SRC's total assets at the end of the last two completed fiscal years must be disclosed). However, an SRC is not required to disclose its review, approval, or ratification policies and procedures concerning related party transactions (Item 404(b)). Because many SRCs tend to be closely held, the Commission staff often issues comments pertaining to related party transactions related to forgiveness of debt and contributed services. The Commission staff has also noted that disclosures should not claim that transactions have been recorded at an arm's length unless the SRC has objective evidence to support that assertion.

Corporate Governance (Item 407)
SRCs are not required to provide information related to Compensation Committee Interlocks and Insider Participation, or a Compensation Committee Report. (407(e)(4) and (5).

Risk Factors (Item 503)
SRCs are not required to provide information regarding the ratio of earnings to fixed charges, or, in connection with

Forms 10, 10-K, or 10-Q, to provide risk factors. However, we believe that most SRCs should provide risk factor disclosure in order to take advantage of the safe harbor for forward looking statement set forth in Section 21E of the Securities Exchange Act of 1934, as amended.

Exhibits (Item 601(b)(12))

SRCs are not required to provide Exhibit 12, Statements re: Computation of Ratios.

In addition to the scaled disclosures listed above, SRCs have a longer period of time than larger companies to make their periodic filings: annual reports on Form 10-K are due within 90 days following the company's fiscal year end, and quarterly reports on Form 10-Q are due within 45 days following the company's preceding fiscal quarter.

Recent Dodd-Frank Act Provisions

In connection with the recent adoption of the Dodd-Frank Act, there are a number of new requirements applicable to proxy statements filed by public companies.

Say-on-Pay and Say-on-Frequency

A SRC does not have to comply with the "say-on-pay" and "say-on-frequency" requirements adopted under the Dodd-Frank Act until its first annual meeting at which directors will be elected, and for which disclosure regarding executive compensation will be required, which occurs on or after January 21, 2013. However, all public companies, including SRCs, holding an annual or other meeting on or after January 21, 2011, will be required to submit to shareholders for an advisory vote on any "golden parachute" compensation to be paid in connection with change-of-control transactions.

Independent Compensation Committee

The Commission is obligated to issue rules requiring national securities exchanges prohibiting them from listing any equity security of a company if its board of directors does not have an "independent" compensation committee. The Commission is also required to issue rules directing national securities exchanges to adopt listing standards containing explicit authority for compensation committees to engage their own independent advisors. Proposed rules on these compensation committee matters are expected to be issued in March 2011, with final rules being adopted during or before July 2011.

Pay for Performance Disclosure

The Commission is obligated to adopt rules that require companies to provide in any proxy statement for an annual meeting disclosure that shows the relationship between executive compensation actually paid by the company and the company's financial performance, which disclosure may be included in a graphic representation. The Commission currently predicts that these rules will be adopted sometime between April and July 2011.

Internal Pay Ratio Disclosure

The Commission is obligated to adopt rules that require disclosure of (1) the median total annual compensation of all employees of the company other than the CEO; (2) the total annual compensation of the company's CEO; and (3) the ratio of the two amounts. The issuance of proposed rules on this topic is expected to occur sometime between August and December 2011.

Incentive Compensation Clawback

The Commission is required to adopt rules for national securities exchanges to adopt listing standards so that listed companies must develop and implement policies to "claw back" executive compensation in the event of a financial restatement. These claw back rules are predicted to be adopted sometime between August and December 2011.

We also note that the Commission has recently published some interpretive advice relating to SRCs. These interpretations are available at www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm#169-01. Note that the Commission rules and interpretations are subject to regular modifications.

The Commission has made available the following information on its website relating to SRCs:

- Contacting the SEC Office of Small Business Policy: www.sec.gov/info/smallbus/reachsec.htm
- Information For Small Businesses: www.sec.gov/info/smallbus.shtml
- Small Business Compliance Guides: www.sec.gov/info/smallbus/secg.shtml
- Completed Initiatives of Interest to Smaller Reporting Companies: www.sec.gov/info/smallbus/sbrules.shtml
- SEC Advisory Committee on Smaller Public Companies, Final Report 20-21 (2006) available at www.sec.gov/info/smallbus/acspc.shtml

Conclusion

SRCs have unique disclosure and corporate governance concerns in comparison to larger public companies. Among the benefits of being an SRC is the ability to comply with the less onerous disclosure obligations. A further benefit, resulting from the Dodd-Frank Act, is the exemption for SRCs from the auditor attestation requirements of Section 404(b) of SOX. In addition to the issues discussed above, there may be other reasons why a company may want to think about either qualifying for or exiting the SRC regime. For example, companies should keep in mind the status of their competitors and whether qualifying as an SRC may negatively impact market perception of the company. Given the complexity of the federal securities laws, it is prudent to consider some of these issues sufficiently in advance. As the old proverb goes, sometimes a good plan today is better than a perfect plan tomorrow.

Sanjay M. Shirodkar is of counsel in DLA Piper's Public Company and Corporate Governance practice and previously served as special counsel with the SEC and Kristi Darnell-Weichelt is an associate in DLA Piper's Public Company and Corporate Governance Practice.