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SEC Proposes Amendments to Disclosure and Reporting Requirements for Smaller Companies

The SEC has proposed for public comment amendments to its disclosure and reporting regimes under both the Securities Act and the Exchange Act to extend the benefits of the scaled disclosure and reporting requirements currently in place for small business issuers to a much larger group of companies. The proposed amendments would create a new category of issuers called “smaller reporting companies,” which would include most companies with a public float below \$75 million. While the proposed amendments would maintain the disclosure requirements currently contained in Regulation S-B, they would integrate the provisions of Regulation S-B into Regulation S-K. In addition, the proposed amendments would eliminate the “SB” forms currently used by small business issuers in connection with the registration of their securities and periodic reporting and provide for registration and reporting by smaller reporting companies on the forms currently used by larger companies. The SEC is also soliciting suggestions for additional ways to better scale its disclosure and reporting requirements to the needs of smaller reporting companies and their investors. The proposed amendments are subject to a 60-day comment period, which expires on September 17, 2007.

Background

Because of the unique role that small business has historically played as a driver of economic activity, innovation, and job creation in the United States, the SEC has made consistent efforts not to subject smaller companies and their investors to unduly burdensome federal securities regulation. In March 2005, the SEC chartered the Advisory Committee on Smaller Public Companies, charged with assessing the current regulatory system for smaller companies under the federal securities laws. The proposed amendments stem from recommendations of the Advisory Committee.

“Small business issuers” are currently eligible to make required disclosures based on Regulation S-B, which sets forth disclosure standards for small business issuers that must file documents with the SEC under the Securities Act, Exchange Act, or Trust Indenture Act. In most cases, small business issuers may make disclosures based on Regulation S-B only if they use one of the designated forms, including Forms 10-SB, 10-QSB, 10-KSB, SB-1, and SB-2. One key provision of Regulation S-B is Item 310, which governs the form, content, and preparation of financial statements for companies that provide disclosure pursuant to Regulation S-B and are less detailed than the requirements in Regulation S-X, which governs the financial statements

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disclosure of most companies that do not rely on Regulation S-B. Regulation S-B also contains a number of disclosure requirements that are scaled to the characteristics of smaller companies, including requirements on executive compensation, related person transactions, and management's discussion and analysis of financial condition and results of operations.

In addition to these scaled disclosure requirements, smaller companies are also currently subject to less rigorous filing deadlines than larger companies. Smaller companies qualifying as "non-accelerated filers" may file their annual reports no later than 90 days after fiscal year end and their quarterly reports no later than 45 days after the end of each fiscal quarter, in contrast with the 60-day and 75-day deadlines for the annual reports of large accelerated filers and accelerated filers, respectively, and the 40-day deadline for quarterly reports of those larger companies. Non-accelerated filers are also treated differently with regard to the compliance dates applicable to the internal control over financial reporting provisions in Section 404 of the Sarbanes-Oxley Act.

The proposed amendments are intended to simplify, and expand significantly eligibility to use, the scaled disclosure and reporting regimes available to smaller companies, consistent with investor protection. The proposed amendments would make such scaled disclosure and reporting regimes available to 4,976 companies, which constitutes 42% of the 11,898 companies that filed annual reports under the Exchange Act in 2006, a significant increase from the 3,395 reporting companies that currently use the scaled disclosure and reporting regimes.

Expanding Eligibility for Smaller Company Scaled Regulation

The proposed amendments would expand the availability of scaled disclosure and reporting requirements currently in place for small business issuers to most companies with a public float below \$75 million. This new category of companies, called "smaller reporting companies," would replace the category of "small business issuer," which is defined as a U.S. domestic or Canadian company with revenues and a public float of less than \$25 million each that is not an investment company or asset-backed issuer.

The proposed maximum public float of \$75 million is intended to harmonize the eligibility for smaller reporting company status with certain other federal securities law areas. In addition to the use of the \$75 million public float metric in the definition of accelerated filer, the SEC used the \$75 million public float requirement in its proposed amendments to expand eligibility to use Form S-3 and Form F-3. Like the new category "smaller reporting companies," the category "non-accelerated filers" consists of most companies with a public float of less than \$75 million. As a result, although the SEC would continue to use the term "non-accelerated filer," the proposed definition of "smaller reporting company" would include most companies classified as non-accelerated filers.

Quantitative Standards in the Proposed Definition of "Smaller Reporting Company"

Public Float of Less than \$75 Million

The proposed definition of "smaller reporting company" would include most companies that have a public float of less than \$75 million, adjusted for inflation approximately every five

years. Unlike the definition of “small business issuer,” such proposed definition would not include a revenue test for most companies. Under the proposed amendments, the public float of an Exchange Act reporting company would be calculated by multiplying the number of outstanding shares of common equity held by non-affiliates by the price at which its common equity was last sold or the average of the bid and ask prices of its common equity in the public market as of the last business day of the company’s second fiscal quarter. This date of determination is consistent with the current practice for establishing accelerated filer status.

In connection with a Securities Act registration statement for an initial public offering of common equity, however, a company would calculate its public float as of a date within 30 days of the date it files the initial registration statement. Such non-reporting companies would compute public float by multiplying the aggregate of the number of outstanding shares of common equity held by non-affiliates before the public offering plus the number of such shares included in the registration statement by the estimated public offering price of the shares. This method of calculation represents a departure from current practice in determining public float for purposes of establishing “small business issuer” status, which is calculated based only on the number of shares of common equity outstanding before the public offering without consideration of the shares included in the registration statement.

In connection with a company’s initial Exchange Act registration statement covering a class of securities, the company would calculate its public float as of a date within 30 days of the date it files such registration statement. Because such an Exchange Act registration statement would not directly affect the company’s public float, if a company that files an Exchange Act registration statement does not have a public float or its public float cannot be calculated because there is no market price for its equity securities, the company’s qualification as a “smaller reporting company” would be based on its annual revenues, as described below.

Annual Revenues of Less than \$50 Million

While the proposed definition of “smaller reporting company” does not generally apply a revenue standard, companies that do not have a public float as defined because they have no significant public common equity or no market price exists for their common equity, such as a company with only debt publicly outstanding, may qualify as a “smaller reporting company” if they have reported annual revenues of less than \$50 million (adjusted for inflation approximately every five years) in its most recently completed fiscal year for which audited financial statements are available.

Exclusions from the Definition of “Smaller Reporting Company”

The current definition of “small business issuer” excludes companies that are not organized in the United States or Canada, investment companies, and asset-backed issuers. Under the proposed amendments, the definition of “smaller reporting company” would continue to exclude investment companies and asset-backed issuers, but all foreign companies that meet the applicable quantitative standards would be able to qualify as smaller reporting companies. Forms S-1, S-3, S-4, 10-Q, and 10-K would allow scaled disclosure for “smaller reporting companies,” while Forms F-1, F-3, F-4, and 20-F, available only to foreign private issuers (as defined in Securities Act Rule 405), would not permit such scaled disclosure. For this reason, foreign private

issuers that also qualify as smaller reporting companies could choose whether to provide disclosure based on (a) the domestic forms with the scaled reporting requirements for smaller reporting companies or (b) the foreign forms with the disclosure requirements of those forms unaffected by smaller reporting company status.

Integration of Requirements of Current Regulation S-B into Regulation S-K

Under the proposed amendments, the provisions of Regulation S-B would be integrated into Regulation S-K without any major substantive changes to former provisions of Regulation S-B. Where the disclosure standards of identically numbered items in Regulation S-B and Regulation S-K are substantively the same for smaller reporting companies and larger companies, the proposed amendments would not change the existing Regulation S-K disclosure items. Otherwise, the proposed amendments would add a new paragraph to each item of Regulation S-K that would contain separate disclosure standards for smaller reporting companies. Although the disclosure requirements for smaller reporting companies would remain substantially the same as those currently set forth in Regulation S-B for small business issuers, the proposed amendments would make the following minor substantive changes.

Substantive Changes from Current Requirements of Regulation S-B

Item 310: Financial Statements

Under the proposed amendments, new Item 310 would be added to Regulation S-K to set forth the alternative requirements on form and content of financial statements for smaller companies that now appear in Item 310 of Regulation S-B. The only substantive change in proposed Item 310 of Regulation S-K that would differentiate it from current Item 310 of Regulation S-B is that the proposed amendments would require foreign issuers who elect to use Item 310 disclosure for smaller reporting companies (instead of reporting on the foreign forms as described above) to present financial statements pursuant to U.S. GAAP, in lieu of presenting financial statements in home country GAAP along with a reconciliation to U.S. GAAP as is currently permitted by Item 310 of Regulation S-B.

Item 404: Transactions with Related Persons, Promoters, and Certain Control Persons

Item 404 of Regulation S-B requires disclosure regarding transactions with related persons, promoters, and certain control persons where the amount exceeds the lesser of 1% of a small business issuer's total assets or \$120,000, while companies using Regulation S-K are required to disclose information only about such transactions where the amount exceeds \$120,000. Because of this difference, small business issuers for which 1% of their assets is less than \$120,000 are currently required to provide more rigorous related person disclosure under Item 404 than larger companies. Small business issuers are also currently required to disclose additional specific information about underwriting discounts and commissions and corporate parents. The proposed amendments would change the calculation of total assets for smaller reporting companies from 1% of their total assets based on the average of total assets at year end for the last three completed fiscal years to the last two completed fiscal years. This standard is more consistent with the two years of financial statements required of smaller reporting companies in the filings containing these disclosures.

A La Carte Approach

In order to encourage smaller reporting companies to determine for themselves the proper balance and mix of disclosure for their investors within the boundaries of the baseline of required disclosure established in the proposed amendments, companies that qualify as smaller reporting companies would be permitted to choose on an item-by-item, or “a la carte,” basis to comply with either the scaled disclosure requirements for smaller reporting companies or the disclosure requirements for larger companies, both as set forth in Regulation S-K, when the requirements for larger companies are more rigorous. The only exception to this would be the requirement that smaller reporting companies provide financial statements on the basis of either Item 310 or Regulation S-K or Regulation S-X for an entire fiscal year and not change back and forth from one to the other in different filings within a single fiscal year.

Eliminating S-B Forms

The proposed amendments would eliminate forms associated with Regulation S-B (including Forms 10-SB, 10-QSB, 10-KSB, SB-1, and SB-2) and instead add a check box to the cover page of all forms in which smaller reporting companies may take advantage of the alternative disclosure requirements. The check box would require smaller reporting companies to indicate their status as such and therefore alert investors and others reviewing the filing that the disclosing company is eligible to comply with the scaled disclosure requirements available to smaller reporting companies.

One notable result of this elimination of the forms associated with Regulation S-B is that most smaller reporting companies would use Form S-1 to offer securities to the public instead of Form SB-1. Unlike the Regulation S-B forms, Form S-1 permits an Exchange Act reporting issuer to incorporate by reference its previously filed Exchange Act reports if it (a) has filed an annual report for its most recently completed fiscal year, (b) has filed all reports and other materials required to be filed by Exchange Act Sections 13(a), 14, or 15(d) during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (c) makes available all incorporated materials on its Internet site. This ability to incorporate previously filed reports by reference is expected to result in some cost savings and efficiencies in preparing registration statements for smaller reporting companies.

Transition to and from Smaller Reporting Company Status

Transition from Smaller Reporting Company Status

Under the current regulatory regime, a small business issuer that exceeds the \$25 million revenue and \$25 million public float ceilings at the end of two consecutive fiscal years must transition out of small business issuer status, effective immediately for filings covering events and completed fiscal periods in the next fiscal year. By contrast, a non-accelerated filer must transition to accelerated filer status in the next fiscal year after its public float first rises above \$75 million as of the last business day of its most recently completed second fiscal quarter. The proposed amendments would follow the transition model currently used to determine accelerated filer status, and smaller reporting companies would lose eligibility to claim that status in the first

fiscal year following a fiscal year in which the smaller reporting company's public float rises above \$75 million as of the last business day of the second fiscal quarter.

Transition to Smaller Reporting Company Status

Under the current regulatory regime, a reporting company may transition to small business issuer status in the next fiscal year if its revenues and public float fall below \$25 million at the end of two consecutive fiscal years. An accelerated filer may transition to non-accelerated filer status in the next fiscal year if its public float falls below \$50 million as of the last business day of the company's second fiscal quarter. The proposed amendments would again follow the transition model currently used to determine accelerated filer status, and a reporting company that does not file reports claiming smaller reporting company status would transition to that status in the next fiscal year if its public float falls below \$50 million as of the last business day of the company's second fiscal quarter.

Under the proposed amendments, companies that do not have a public float as defined because they have no significant public common equity or no market price exists for their common equity and that have less than \$50 million in annual revenues would qualify as smaller reporting companies and be eligible to use the scaled disclosure requirements until they exceed \$50 million in annual revenues. Once a company fails to qualify for smaller reporting company status under this revenue test, it would remain unqualified unless its annual revenues fall below \$40 million during the previous fiscal year.

Date of Determination

Under the proposed amendments, a company's qualification as a smaller reporting company would be determined at the beginning of a fiscal year on the basis of the information in a quarterly report on Form 10-Q or an initial registration statement under the Securities Act or Exchange Act, whichever is the first to be filed during that year. If a company that qualified as a smaller reporting company on the basis of the revenue test described above develops a public float or its public float increases during the year, the company would nevertheless remain a smaller reporting company for the entire fiscal year.

Elimination of Transitional Small Business Issuer Format

As part of the adoption of Regulation S-B and later additional small business initiatives, the SEC developed a transitional registration statement (Form SB-1) and annual report (Form 10-KSB) allowing disclosure based on Model A or B found in Regulation A. Because the transitional disclosure format is not commonly understood and infrequently used, the proposed amendments would eliminate this disclosure option, and smaller reporting companies would instead use Form S-1 and 10-K.

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This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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