

# SEC Expands Definition of Smaller Reporting Company

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Capital Markets and Securities

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On June 28, 2018, the Securities and Exchange Commission (the “SEC”) issued a final rule amending the definition of “smaller reporting company” (“SRC”) to expand the number of registrants that will qualify for the scaled disclosure requirements applicable to SRCs. Under SEC Chairman Jay Clayton’s direction, the SEC has focused on easing restrictions on smaller companies to promote capital formation, and the expansion of scaled disclosure to a larger subset of small companies follows that trend. The SEC expects that nearly 1,000 companies which are not currently SRCs will now be eligible for such status.

Under the final rule, an issuer will be a SRC if it has either (1) a public float of less than \$250 million or (2) an annual revenue of less than \$100 million and public float of less than \$700 million. The final rule will become effective 60 days after publication in the Federal Register.

## Changes to Current Standards

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The SEC created the SRC category in 2007 and implemented scaled disclosure requirements for SRCs. The scaled disclosure requirements were intended to ease the compliance burden on smaller registrants in order to promote capital formation and reduce compliance costs while still maintaining investor protections.<sup>1</sup> Under this existing regime, a company qualifies as an SRC with either (1) a public float of less than \$75 million or (2) less than \$50 million in annual revenues if the company has no public float. Generally, in determining whether it is an SRC, a company must calculate the value of its public float—the company’s outstanding shares held by non-affiliates—as of the last business day of the company’s most recently completed second fiscal quarter.

The SEC proposed amendments to increase the thresholds for qualification as an SRC in June 2016. In crafting the final rule, the SEC considered comment letters submitted in response to the proposal and recommendations from the SEC’s Advisory Committee on Small and Emerging Companies and the SEC Government-Business Forum on Small Business Capital Formation.

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<sup>1</sup> Prior to the creation of the SRC rules, Regulation S-B provided scaled disclosure for a more limited group of “small business issuers.”

The amended definition follows the two-pronged approach of the existing definition, retaining a public float test and an annual revenue test. SRCs will now include issuers that have (1) a public float of less than \$250 million or (2) revenue of less than \$100 million for the previous fiscal year and a public float of less than \$700 million. The proposing release contemplated that only companies with no public float would fall into the second category, but the final rule allows companies with less than \$700 million in public float to qualify as SRCs under the revenue test. Amendments to Securities Act Rule 405, Exchange Act Rule 12b-2, and Item 10(f) of Regulation S-K will implement these changes. The scaled disclosure rules in Regulation S-K and Regulation S-X remain unchanged, and companies are still free to include non-scaled information as they choose. For convenience, Appendix A summarizes the changes to the SRC definition.

In another deviation from the proposing release, the final rule amends Rule 3-05(b)(2)(iv) of Regulation S-X to increase the net revenue threshold for “acquired” or “to be acquired” companies qualifying for certain scaled reporting requirements. An acquirer may omit the earliest of three required years of audited financial statements of a target that exceeds the 50% significance test threshold but reported net revenue of less than \$100 million in the most recent fiscal year. This revenue threshold is being raised from \$50 million under current Rule 3-05(b)(2)(iv).

## Regaining SRC Status

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To help avoid situations in which companies might move in and out of SRC status based on small changes to public float or revenue, the final rule, consistent with the current definition, provides that after losing SRC status a company must meet a lower threshold under either test to regain status as an SRC. As amended, the thresholds at which a company may now regain its status as an SRC are as follows:

- less than \$200 million of public float if the company previously had \$250 million or more of public float (up from \$50 million of public float under current rules); or
- less than \$80 million of annual revenues if the company previously had \$100 million or more, and less than \$560 million of public float if it previously had \$700 million or more of public float (up from \$40 million of revenues and no public float under current rules).

For the first fiscal year ending after the final rule becomes effective, a current public company may use the initial qualification standards (rather than these standards) to determine whether it qualifies as an SRC.

## Looking Forward

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The SEC also amended the definitions of “accelerated filer” and “large accelerated filer” under Exchange Act Rule 12b-2 to preserve the existing thresholds for accelerated filer status and to eliminate an exception from accelerated or large accelerated status for SRCs. The result is that an SRC with a public float between \$75 million and \$250 million will remain subject to accelerated filing deadlines,<sup>2</sup> as well as the requirement to provide in its annual report the

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<sup>2</sup> See Form 10-K General Instructions and Form 10-Q General Instructions.

registered public accounting firm's attestation report on the company's internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act.<sup>3</sup>

The adopting release states that the "Chairman has directed the staff to formulate recommendations to the Commission for possible additional changes to reduce the number of registrants that our rules define as accelerated filers," which would reduce the number of registrants subject to the attestation requirement under Section 404(b). The SEC remains divided on whether that change should be made. In considering this rulemaking, Commissioner Kara M. Stein said that in a 2011 study the SEC staff "found no specific evidence that any potential savings from exempting [companies with public floats between \$75 million and \$250 million] from section 404(b) would justify the loss of investor protections. Rather, our staff found that companies that were subject to section 404(b) generally had a lower rate of financial statement errors than those that were not." Conversely, in approving the rulemaking, Commissioner Hester M. Peirce called for a change to the 404(b) requirement: "I am voting in favor of this rule today because it is evidence of this Commission's and this Chairman's commitment to capital formation. The real change will not come until we tackle 404(b) in the coming months."

## Appendix A

### Summary of New "Smaller Reporting Company" Definition

	Criteria	Current Threshold	Amended Threshold
Initially Becoming a Smaller Reporting Company	Public Float Test	Public float of less than \$75 million	Public float of less than \$250 million
	Revenue Test	Revenue less than \$50 million; no public float	Revenue of less than \$100 million, public float of less than \$700 million
Regaining Status as a Smaller Reporting Company	Public Float Test	Public float of less than \$50 million	Public float of less than \$200 million (if previously had \$250 million or more of public float)
	Revenue Test	Revenue less than \$40 million; no public float	Revenue of less than \$80 million (if previously had \$100 million or more of revenue) and less than \$560 million of public float (if previously had \$700 million or more of public float).

<sup>3</sup> See Regulation S-K Item 308(b).

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