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UPDATES TO THE PUBLIC COMPANY DISCLOSURE RULEBOOK

The Securities and Exchange Commission and Congress are taking steps to reduce the burdens and costs of being a public company. In this six-part article, the authors address this effort, describing the state of the SEC, new amendments to simplify disclosure requirements, and proposed rule changes to promote capital raising and increase the number of public companies. The authors then turn to the SEC's requests for comments on possible elimination of quarterly reporting and revisions to the rules governing private capital markets and pending legislation in Congress.

By Hillary H. Holmes and Jordan G. Rex *

The Securities and Exchange Commission and the Congress have recently shown a concerted effort to encourage capital formation and lessen the burden of reporting requirements for both public and private companies. Current SEC Chairman Jay Clayton outlined his views on this point, saying, "[i]t is important for the SEC to review our regulations to ensure that they are consistent with our ever-evolving capital markets."[1] The primary purpose of this article is to provide an overview of the SEC's recent efforts to follow through with that statement.[2]

Part I of this article begins by providing an overview of the current state of the SEC, including a brief discussion of the current SEC commissioners and the political climate surrounding the recent activity. Part II considers new amendments that simplify certain disclosure requirements found in Regulation S-K and Regulation S-X, as well as other rules and forms. Part III outlines the SEC's new and expanded definition of a "smaller reporting company" (or "SRC"), which is expected to include almost half of all public companies. Part IV follows with a discussion of amendments to Rule 701 of the Securities Act of 1933, which permit more public companies to issue equity-based compensation without disclosing it to investors. Part V reviews the SEC's pending requests for public comment, including the possible elimination of quarterly reporting. Part VI concludes with a discussion of the proposed legislation called the JOBS and Investor Confidence Act of 2018 and other proposed bills. Each part will be addressed in turn.

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[1] Jay Clayton, *Remarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival*, August 29, 2018, *available at* https://www.sec.gov/news/speech/speech-clayton-082918.

[2] This article is current as of July 31, 2019.

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PART I – STATE OF THE SEC

Before diving into a discussion regarding the recent and proposed changes to the regulations, it is important to understand the background surrounding these changes and ask why they are happening. The short answer is — the federal government is focused on the promotion of capital-raising and increasing the overall number of public companies in the United States.

Throughout the modern era, the publicly traded corporation has been a cornerstone of our nation's economy. It enables enterprises to raise money from the broadest possible group of investors and it allows almost anyone — from my 95-year-old grandmother in rural Colorado to the most sophisticated institutional investment fund on Wall Street — to invest in, and earn a profit from, the ventures of others. In the last few years, however, the universe of these "cornerstone" companies in the United States has been shrinking and, as of late, more capital is being raised privately than publicly. For example, new businesses have been offering shares to the public at less than half the rate of the 1980s and 1990s.[3] At the end of 2017, there were about 3,600 firms listed on U.S. stock exchanges, which is less than half the number of similar firms in 1997. The big tech companies that would have gone public in eras past are staying private, dramatically limiting which investors have the opportunity to profit from their rapid growth and success.

The SEC has flagged this as a problem. Jay Clayton, Chairman of the SEC, has called the seeming decline of the traditional U.S.-listed public company as "a serious issue for our markets and the country more generally," and said that the "potential lasting effects [to] the economy and society are, in two words, not good."[4] The SEC and Congress have attacked this problem on two fronts: first, by adopting specific changes to the securities offering process itself (such as allowing testing the waters before an initial public offering ("IPO") and confidential submission of registration statements); and second, by reducing the burdens and costs of being a public company. It is the latter of these methods that this article will address.

Current State of the Commission

The SEC has five commissioners who are appointed by the President with the advice and consent of the Senate. Because each commissioner serves a five-year, staggered term, one of each of the five commissioners' terms ends on June 5th of each year. No more than three commissioners may belong to the same political party. The President designates one of the five commissioners to serve as Chairman. Chairman Clayton (a former corporate partner at a large firm) is an Independent who was sworn in on May 4, 2017 and whose term expires in 2021. The last chair, Mary Jo White, was a former prosecutor who seemed focused on the SEC's enforcement program, with an eye to policing minor technical violations of the law (commonly referred to as "broken windows"). However, each chair adds his or her own focus to the SEC, and Chairman Clayton is focused on protection of the capital markets, technology, and enforcement actions against those who prey on retail investors.

The other commissioners currently serving are Robert J. Jackson, Jr., Hester M. Peirce, Elad L. Roisman, and Allison H. Lee. Commissioner Jackson (a former Professor of Law at NYU School of Law) is a Democrat who was sworn in on January 11, 2018 and whose term expired on June 5, 2019[5]; Commissioner Peirce (a former Senior Research Fellow and Director of the Financial Markets Working Group at the Mercatus Center at George Mason University) is a Republican who was sworn in on January 11, 2018 and whose term expires in 2020; and Commissioner Roisman (a former Chief Counsel of the U.S. Senate Committee on Banking, Housing, and Urban Affairs) is a Republican who was sworn in on September 11, 2018, and whose term expires in 2023. Most recently, on July 8, 2019,

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[3] Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, *available at* https://site.warrington.ufl.edu/ritter/files/2018/01/IPOs2017Statistics_January17_2018.pdf.

[4] Jay Clayton, *Remarks at the Economic Club of New York*, *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[5] Commissioner Jackson has not indicated when he plans to officially step down from his post, but he is permitted by law to continue serving through the end of 2020.

Commissioner Lee (a former securities partner and SEC staff member from 2005 to 2018) was sworn into office filling the vacancy opened since Kara Stein's 18-month tail period expired on December 31, 2018 and finally bringing the SEC back to full strength.

There have also been changes to the Staff of the SEC over the last several years. Perhaps most significant to this discussion, the Division of Corporation Finance got a new Director, William H. Hinman, in May 2017. Chairman Clayton noted in the SEC's announcing release that "[Mr. Hinman] understands the SEC's mission to promote capital formation while ensuring that investors have the information necessary to make informed decisions."[6]

In his spring 2018 testimony before the House Financial Services Committee, Mr. Hinman articulated a consistent view:

> Against the backdrop of a declining number of U.S. public reporting companies, the Division has been looking at ways to make the public company alternative more attractive. While there are many reasons why companies may choose not to go public, to go public at a later stage, or to exit the public markets, to the extent we are able to attract more companies to join our public companies reporting system and do so at an earlier stage, it will ultimately benefit companies, our markets and investors. Although initial public offerings ("IPOs") and developing public companies may not be suitable for all investors, more IPOs occurring at an earlier stage means a wider range of investors are able to more fully participate in the growth of companies. It is far more efficient for retail investors to invest in companies through our public markets than our private markets. Increasing the number of public companies is becoming more and more important as Americans are increasingly relying upon their own investments for retirement.[7]

Other notable changes include: Robert Stebbins being named General Counsel of the SEC in May 2017, Stephanie Avakian and Steve Peikin being named Co-Directors of the Division of Enforcement in June 2017, Kyle Moffatt being named Chief Accountant of the Division of Corporation Finance in February 2018, Valerie Szczepanik being named Senior Advisor for Digital Assets and Innovations in June 2018, and S.P. Kothari being named Chief Economist and Director of the Division of Economic Risk Analysis in February 2019.

Beyond the SEC, we also have a political climate that is volatile and eager for change. From each of the SEC, the White House, and Congress, we have repeatedly heard since early 2017 that it is a priority for this country to increase capital raising and to have a larger number of publicly traded companies. For example, as further discussed in Part V below, President Trump called for the SEC to study the possibility of eliminating quarterly reporting for public companies. And in December 2018, the Division published a request for public comment on ways to ease a public company's quarterly reporting requirements, while still maintaining appropriate levels of disclosure and investor protection. Likewise, in May 2018, the Securities Industry and Financial Markets Association — the main industry trade group representing securities firms, banks, and asset management companies — issued a report encouraging Congress to reduce high regulatory costs and SEC rules that may discourage companies from going or staying public. The report provided specific and concrete suggestions.

Many of the commissioners' speeches over the last 18 months have been consistent with this theme of trying to strike a balance between lessening the burden of being a public company and investor protection. For example, in early November 2018, at Case Western Reserve University School of Law, Commissioner Peirce discussed proposed changes to certain disclosure requirements and noted, "[o]ur financial reporting and corporate disclosure system is essential to well-functioning markets, which are, in turn, essential to the ongoing provision of the goods and services that make modern lives so safe and comfortable."[8]

[6] *William Hinman Named Director of Division of Corporate Finance*, *available at* https://www.sec.gov/news/press-release/2017-97.

[7] William H. Hinman, *Testimony on "Oversight of the SEC's Division of Corporation Finance*," before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Securities, and Investment, *available at* https://www.sec.gov/news/testimony/testimony-oversight-secs-division-corporation-finance.

footnote continued from previous column…

[8] Hester M. Pierce, *Pondering Financial Reporting: Remarks before the 2018 Leet Business Law Symposium*, *available at* https://www.sec.gov/news/speech/speech-peirce-110218.

The SEC's Strategic Plan

On October 11, 2018, the SEC published its final strategic plan outlining the SEC's priorities through 2022, which is composed of three broad goals: (i) focusing on retail investors, (ii) increasing innovation, and (iii) strengthening performance (the "Plan").[9] The overall theme of the Plan is focused on a modern approach to regulation, including the promotion of capital raising. The Plan was developed through discussions with congressional committees and members of Congress, investors, businesses, academics, and experts, and through the use of meetings, formal outreach programs, SEC-sponsored roundtables, conferences, and broad solicitation. While the Plan's goals are both laudable and lofty, they do not represent a dramatic departure from the SEC's past mission statements.

The Plan's first broad goal is to focus on the long-term interests of "Main Street" investors through five specific initiatives. First, the SEC intends to educate itself on the breadth of investment participation so as to better tailor its resources to the reality of modern capital markets. Armed with this knowledge, the SEC's subsequent mission is to enhance outreach and education in a way that reflects the diversity of modern investors and businesses. Additionally, the Plan expands efforts in enforcement and deterrence of securities manipulation, fraud, and abuse, while also modernizing EDGAR and information delivery to make it easier for investors to acquire, and filers to disseminate, key information. Lastly, and most relevant to this paper, the SEC hopes to increase investment opportunities by expanding the amount of SEC-registered and exchange-listed companies in play.

The second overarching goal for the SEC is to stay abreast of technological innovation, particularly with an eye toward globalization. By continually learning and adapting, the SEC aims to make sure it remains an effective regulator. Moreover, the SEC intends to be self-reflective and self-critical when it comes to its current rules and procedures with the help of public feedback. While addressing the increase in cybersecurity risks for market participants, the SEC aspires to be prepared for any market emergency.

Finally, the last goal is to elevate the SEC's own performance. This is an introspective effort accomplished by promoting diversity, inclusion, and equality among the agency's staff; leveraging data analytics, risk analytics, and data management; and actively investing in tools that uncover violations of securities laws. In connection with this last goal, the SEC named Gabriel Benincasa[10] as its first Chief Risk Officer — a newly established position created by Chairman Clayton — to strengthen the SEC's risk management and cybersecurity efforts.

PART II – DISCLOSURE UPDATES: ELIMINATING DUPLICATION AND OTHER PROPOSALS

Over the past 18 months, the SEC has adopted several amendments to certain disclosure requirements to "simplify compliance without significantly altering the total mix of information."[11] These amendments are the result of a congressional mandate contained in the Fixing America's Surface Transportation Act of 2015 (the "FAST Act"), and form part of the SEC's ongoing initiative to scale or eliminate disclosure requirements to ease the regulatory burden on emerging growth companies, accelerated filers, smaller reporting companies, and other smaller issuers, while still providing all material information to investors.

For example, in August 2018, the SEC adopted several dozen amendments to existing disclosure requirements that it characterized as redundant, duplicative, overlapping, outdated, or superseded in light of subsequent changes to SEC disclosure requirements, U.S. Generally Accepted Accounting Principles ("GAAP"), International Financial Reporting Standards ("IFRS"), and technology developments (the "August 2018 Amendments").[12] And more recently, in March 2019, the SEC voted to adopt several additional amendments "to benefit investors by eliminating outdated and unnecessary disclosure, and making it easier for them to access and analyze material information"[13] (the "March 2019 Amendments," and together with the August 2018 Amendments, the "Final Rules").

In addition to the Final Rules, the SEC continues to propose other amendments (and encourages the public to submit comments on such proposals) that would reduce the burdens on public companies, while ensuring that investors have the information necessary to make

[9] Strategic Plan website, https://www.sec.gov/strategic-plan.

[10] Press Release, https://www.sec.gov/news/press-release/2019-24.

[11] https://www.sec.gov/rules/final/2018/33-10532.pdf.

[12] Adopting Release, https://www.sec.gov/rules/final/2018/33-10532.pdf.

[13] Press Release, https://www.sec.gov/news/press-release/2019-38.

informed decisions. Each of the Final Rules and various other proposed rules and amendments will be discussed in turn.

August 2018 Amendments – A Step in the Right Direction

Although the changes were modest, the August 2018 Amendments were generally viewed as a step in the right direction. For certain disclosure requirements that were related to, but not the same as, GAAP, IFRS, or other SEC disclosure requirements, the SEC: (i) deleted those disclosure requirements that conveyed reasonably similar information to, or were encompassed by disclosures that resulted from compliance with, overlapping U.S. GAAP, IFRS, or SEC disclosure requirements and (ii) integrated those disclosure requirements that overlapped, but required information that was incremental to, other SEC disclosure requirements.

Among other things, the August 2018 Amendments deleted several disclosure requirements that were already covered by GAAP, including (i) financial information about segments for the last three years, (ii) amounts spent on research and development activities for all years presented, (iii) financial information by geographic area, (iv) risks associated with an issuer's foreign operations, and (v) any segment's dependence on foreign operations. Furthermore, reporting companies are no longer required to include historical stock prices or seasonality disclosure in the MD&A of interim reports. The August 2018 Amendments also integrated certain duplicative disclosure requirements related to restrictions on dividends and discussion of geographic areas.

The August 2018 Amendments adopted several changes to (outdated) rules to recognize the availability of modern technology. For example, the SEC removed an unnecessary requirement that reporting companies identify the SEC's Public Reference Room and disclose its physical address and phone number — a much-needed change given the availability of company filings on EDGAR or other internet sources. In addition, the SEC now requires, rather than simply encourages, that a reporting company discloses its website address in public filings.

Finally, the SEC made select changes to Reg. S-X, the prescribed regulation that sets out the specific form and content of financial statements, and reports of public companies. Specifically, as of the end of Q1 for the year-ended 2019, registrants must include a statement of any changes in stockholders' equity in Form 10-Q, something that was previously only required in Form 10-K.

March 2019 Amendments – SEC Continues to Modernize and Simplify Disclosure Requirements

More recently, the SEC voted to adopt the March 2019 Amendments which, among other things, (i) increased flexibility with respect to the discussion of historical periods in MD&A disclosure, (ii) permitted redaction of certain immaterial information from material contracts without submitting an application for confidential treatment, and (iii) changed various SEC form cover pages.[14]

Registrants that provide financial statements covering three years in their filings are no longer required to include in MD&A a discussion of the earliest year if (i) such discussion was already included in any other of the registrant's prior filings that required compliance with Item 303 of Reg. S-K and (ii) registrants identify the location in the prior filing where the omitted discussion can be found. Similarly, the March 2019 Amendments eliminated a reference to five-year selected financial statements and clarified that registrants may use their discretion in selecting the best format for their MD&A presentation. As noted by the SEC, these new changes are expected "to eliminate the burden on registrants to prepare and provide repetitive disclosure that is not material."[15]

Additionally, the March 2019 Amendments made several changes to the exhibit filing requirements that permit registrants to omit disclosure of immaterial information from their public filings. For example, registrants can now omit confidential information from material contracts filed pursuant to Item 601(b)(10)[16] — without requesting confidential treatment from the SEC — where the information is both not material and would likely cause competitive harm to the registrant if publicly disclosed. Similarly, registrants may also omit (i) certain personally identifiable information (*e.g.*, bank account numbers, social security number, home address) on the basis that such information would constitute a clearly unwarranted invasion of personal privacy and (ii) entire schedules and attachments to Item 601 exhibits, provided that such schedules or attachments do

[14] https://www.sec.gov/rules/final/2019/33-10618.pdf.

[15] https://www.sec.gov/rules/final/2019/33-10618.pdf, p. 131.

[16] Note, Item 601(b)(2) was also amended to allow registrants to redact immaterial provisions or terms from agreements filed under this item.

not contain material information not otherwise disclosed in the exhibit or disclosure document. The March 2019 Amendments also added a new exhibit requirement, which requires that registrants provide a brief description of all securities registered under Section 12 of the Exchange Act as an exhibit to their Form 10-K filing in an effort "to increase investors' ease of access to information about the rights and obligations of each class of securities registered."[17]

The March 2019 Amendments also brought several other minor, but important, changes that improve the readability and navigability of disclosure documents. For example, registrants are now required to include disclosure of a registrant's stock ticker symbol for each class of securities registered pursuant to Section 12(b) on the cover pages of its periodic reports and must data tag all information on the cover page in inline XBRL (*i.e.*, embedded directly into the HTML document), which will allow investors to quickly and efficiently identify important information about the particular registrant.

Proposed Amendments – Reducing Certain Financial Reporting Requirements

The SEC has proposed several rule amendments to simplify the financial disclosure reporting requirements applicable to registered debt securities for guarantors and issuers of guaranteed securities, as well as affiliates whose own securities would constitute a portion of the collateral for the securities offered, and, if adopted, would modify Rules 3-10 and 3-16 of Reg. S-X and relocate part of Rule 3-10 and all of Rule 3-16 to new Rules 13-01 and 13-02 of Reg. S-K.[18]

Rule 3-10 currently requires what is commonly referred to as the "guarantor footnote." Generally, a registration statement filed with the SEC must include audited annual and unaudited interim financial statements for the issuer and for all guarantors whose securities are being registered. This is because the SEC views a guaranty as a "security" under the Securities Act. However, there is an exception if the subsidiary-guarantor is wholly owned by the parent-issuer and each guarantee is "full and unconditional" *and* the parent-issuer includes a footnote in its financial statements with consolidating information regarding the guarantor and non-guarantor subsidiaries. Rule 3-10 also requires recently acquired subsidiaries that are "significant" to file pre-acquisition audited financial statements.

If adopted, however, the proposed amendments to Rule 3-10 and new Rule 13-01 would: (i) replace the requirement that a subsidiary issuer or guarantor be 100% wholly owned by the parent company with a requirement that it be consolidated in the parent company's consolidated financial statements; (ii) replace the "guarantor footnote" requirement with a requirement for summarized financial information, which may be presented on a combined basis; (iii) expand the required qualitative disclosures about the guaranties and the issuers and guarantors, as well as requiring disclosure of additional information that would be material to holders of the guaranteed securities; (iv) permit the alternative disclosures to be provided outside the footnotes to the parent company's financial statements, thereby alleviating the time and expense of needing to audit such information; (v) eliminate the requirement to provide pre-acquisition financial statements of recently acquired subsidiary companies and guarantors; and (vi) require the proposed disclosures for as long as the companies and guarantors have an Exchange Act reporting obligation with respect to the guaranteed securities (an obligation that usually lapses in the company's next fiscal year, rather than for as long as the guaranteed securities are outstanding).

Rule 3-16 currently requires separate financial statements for each affiliate whose securities constitute a "significant" portion of the collateral for a secured debt security being offered in a registered offering. To make that determination, the greater of the principal amount, par value, book value, or market value of the affiliate securities is compared to the principal amount of the securities being offered. If it exceeds 20%, separate financial statements of the affiliate are required. Under the proposed amendments, Rule 3-16 would be amended and relocated to Rule 13-02. Specifically, Rule 13-02 would: (i) replace the existing requirement to provide separate financial statements for an affiliate whose securities are pledged as collateral with financial and nonfinancial disclosures about the affiliate and the collateral arrangements; (ii) permit the disclosures to be located outside the company's financial statements; and (iii) replace the requirement to provide disclosure based on the 20% "substantial portion" test with a requirement to provide disclosure in all cases, unless immaterial to holders of the collateralized securities.

Proposed Amendments – Disclosures Relating to Acquisitions and Dispositions of Businesses

On May 3, 2019, the SEC announced proposed changes to existing disclosure requirements in connection with acquisitions and dispositions of businesses to (i) improve financial disclosures

[17] Adopting Release, page 59, https://www.sec.gov/rules/final/2019/33-10618.pdf.

[18] Proposing release, https://www.sec.gov/rules/proposed/2018/33-10526.pdf.

regarding the acquisition and disposition of businesses, (ii) facilitate more timely access to capital, and (iii) reduce the complexity and compliance costs related to such disclosure.[19] These proposed rules, if adopted, would represent another modest but welcomed change for registrants that are involved in M&A activity.

A registrant must generally file financial statements of the target business and pro forma financials of the registrant if the acquisition is deemed "significant" under one of three tests set forth in Rule 1-02(w) of Reg. S-X: an "Investment Test," an "Asset Test," and an "Income Test." At times, these tests have resulted in a technical requirement to prepare and file financial statements of an acquired business even when the acquisition may not be material under other applicable analysis, such as when there is an anomaly in financial results in a particular year. Registrants have also struggled with providing three years of audited financial statements for target businesses that are not subject to SEC reporting requirements. Although the SEC staff has frequently granted waivers that alleviate this burden on a showing of cause, the proposed rules would significantly reduce the circumstances in which the time-consuming and uncertain waiver request process is undertaken.

Among other things, proposed changes include (i) revising the "Investment Test" to compare the investment in, and advances to, the acquired business against the aggregate worldwide market value of the registrant's voting and non-voting common equity, measured as of the last day of the registrant's most recent fiscal year (as opposed to the existing carrying value of the registrant's total assets); (ii) revising the "Income Test" to add a new revenue component and to simplify the calculation of the net income component by using income or loss from continuing operations *after* income taxes, requiring financial statements only if the registrant meets both components of the test; (iii) expanding the circumstances in which a registrant can use pro forma, rather than historical, financial information for significance testing; and (iv) conforming the significance threshold for a disposed business from 10% to 20%.

The proposed changes would also: (i) reduce from three to two years the financial statements required for the acquired business when the relative significance exceeds 50% under any measure, and to require only the most recent interim period (omitting the comparative prior interim period) when relative significance does not exceed 40% under any measure; (ii) expand the circumstances in which separate acquired business financial statements can be omitted once the business has been included in the registrant's post-acquisition financial statements for a complete fiscal year; and (iii) modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required.

In short, if these proposed amendments are adopted, then disclosure requirements would move closer to two core disclosure principles: first, that disclosure should focus on providing material information needed by reasonable investors to make informed investment decisions; and second, that the anticipated benefits of any financial disclosure obligation should outweigh any associated costs.

PART III – SMALLER REPORTING COMPANIES

SEC Amends "Smaller Reporting Company" Definition; Expands Access to Scaled Disclosure Accommodations

On June 28, 2018, the SEC approved amendments to the definition of an SRC, expanding the number of registrants qualifying for SRC scaled disclosure accommodations in their SEC filings. These scaled disclosure accommodations include, among other things, reduced required business, financial, and executive compensation disclosure. The benefits of being an SRC remain unchanged. SRCs can take advantage of reduced disclosure, primarily in the Form 10-K and annual proxy statement. For example, business description is three years rather than five; two years of MD&A comparison rather than three; no quantitative and qualitative disclosures about market risk; two years of financial statements rather than three; executive compensation disclosure was significantly reduced; three named officers rather than five; two years in summary compensation table rather than three; and no disclosure and analysis of the compensation committee report.

Overall, the amendments should benefit a number of public companies with less than $250 million of public float, as well as public companies with revenues of less than $100 million and less than $700 million of public float. One industry that may benefit from the amendments is the biotechnology and life sciences sector, where a significant number of additional companies will now be able to qualify for SRC status. In addition, it will also benefit companies whose stock prices have declined dramatically in light of market or industry conditions, such as in the smaller side of the oil and gas sector. The SEC estimates that 966 additional

[19] https://www.sec.gov/rules/proposed/2019/33-10635.pdf.

registrants will be eligible for SRC status in the first year under the amended definition, and approximately 48.8% of SEC registrants will now qualify as SRCs (as compared to approximately 35.7% previously).

As revised, Rule 12b-2 under the Exchange Act of 1934, Rule 405 of the Securities Act, and Item 10(f) of Reg. S-K, define an SRC as an issuer that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that meets one of the two tests outlined below.

The Maximum Public Float Increases from $75 Million to $250 Million. First, the amendments increased the maximum public float of an SRC to $250 million from the previous level of $75 million. If a company's public float exceeds $250 million, then it must drop below $200 million in order to qualify as an SRC. Per the SEC's announcement, "once a registrant determines that it does not qualify as an SRC under the applicable thresholds, it will not subsequently qualify until its public float falls below another, lower threshold, set at 80% of the initial qualification threshold." This 80% relationship is consistent with the prior rule. The SEC noted that these thresholds are necessary to avoid situations in which registrants frequently enter and exit SRC status due to small fluctuations in their public float. The SEC also clarified:

> For purposes of the first fiscal year ending after effectiveness of the amendments, a registrant will qualify as an SRC if it meets one of the initial qualification thresholds in the revised definition as of the date it is required to measure its public float or revenues . . . , even if such registrants previously did not qualify as a SRC.

For example, a public company with a December 31 fiscal year-end that is currently an SRC would qualify as an SRC for the fiscal year ended December 31, 2018 if the company had a public float of less than $250 million as of June 30, 2018 (the last business day of its most recently completed second fiscal quarter). The scaled disclosure and other requirements applicable to SRCs were first available with respect to such company's Annual Report on Form 10-K for 2018 and its Quarterly Reports for the third and fourth quarters of 2018.

However, the amendments did not change the method for calculating public float, which is computed by multiplying the aggregate world-wide number of shares of a registrant's voting and non-voting common equity held by non-affiliates by the price at which the common equity was last sold, or the average of the bid and asked prices of common equity, in the principal market for the common equity. For registrants required to file reports under Section 13(a) and 15(d) of the Exchange Act, the determination is made as of the last business day of the registrant's most recently completed second fiscal quarter. In connection with the filing of an initial registration statement with the SEC, a registrant must choose a date that is within 30 days of the filing to determine SRC eligibility.

The Maximum Annual Revenue Increases from $50 Million to $100 Million. In addition, the amendments permit a registrant to qualify as an SRC if such registrant (i) has less than $100 million in annual revenues during the most recent fiscal year, and either (a) has no public float or (b) a public float of less than $700 million. Under the old rules, to qualify as an SRC, registrants must have had annual revenue of less than $50 million and no public float. In explaining the rule, the SEC noted that "low-revenue registrants would benefit from the cost savings of scaled disclosure accommodations and could redirect those savings into growing their businesses without significantly detracting from investor protections." As with the public float test, once a registrant exceeds these thresholds, it must meet new lower thresholds in order to qualify as an SRC: $80 million of annual revenue and $560 million of public float.

No Changes to the SEC's Definition of "Accelerated Filer" — Yet

These amendments did not change the $75 million public float threshold in the "accelerated filer" definition and, at least for now, some SRCs will continue to remain subject to the accelerated reporting deadlines and the requirement for an auditor attestation on internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act, the latter of which can result in costs of as much as $6 million. However, in line with the theme of reducing the burdens of being a public company, the SEC proposed changes to the accelerated filer and large accelerated filer definitions on May 9, 2019.[20]

Among other things, the proposed changes would exclude from the accelerated and large accelerated filer definitions certain issuers that (i) are eligible to be an SRC and (ii) had annual revenues of less than $100 million in the most recent fiscal years for which audited financial statements are available. While the proposed

[20] Press release, https://www.sec.gov/news/press-release/2019-68.

changes would result in more lenient filing deadlines for some issuers, a potentially more significant impact is that, by increasing the number of non-accelerated filers, the changes would increase the number of issuers that are exempt from the requirement to have an auditor attest to management's assessment of internal control over financial reporting ("ICFR").

In a public statement of dissent, Commissioner Jackson argued that the proposal to roll back the requirement that auditors attest to the adequacy of certain companies' internal controls had "no apparent basis in evidence," alleging that the analysis of the costs of attestation was based on data over a decade old. In a separate public statement, however, Chairman Clayton emphasized the experience the SEC had with emerging growth companies ("EGCs") over the last six years and the additional benefits the proposed amendments will bring to the market, considering the shrinking size of the companies represented in the public markets.[21] Similarly, Commissioner Roisman pointed out that the cost of compliance with the auditor attestation requirement disproportionately affects SRCs and noted that "there are many other protections in place to ensure accurate financial statements in the absence of a 404(b) ICFR auditor attestation requirement."[22]

Increased Threshold to Exclude Older Acquisition Financials

In June 2018, the SEC also amended Rule 3-05 of Reg. S-X to allow a non-SRC registrant to omit certain acquisition financial statements. Rule 3-05 of Reg. S-X sets forth the requirements for financial statements of an acquired or to-be-acquired business. As part of the SEC's amendments relating to SRCs, the SEC also amended Rule 3-05(b)(2)(iv) of Reg. S-X to permit registrants to omit financial statements of the target business for the earliest of the three years required by the rule if net revenues of the target business were less than $100 million in its most recent fiscal year, instead of $50 million as currently provided by the rule. This is consistent with the theme of focusing disclosure on more material information.

Updates to Related Guidance

On November 7, 2018, the Staff of the Division of Corporation Finance released four updated, and withdrew six, Compliance and Disclosure Interpretations ("C&DIs") in light of the June 2018 amendments to the definition of an SRC. Similarly, the New York Stock Exchange has proposed corresponding changes to Section 303A.00 of the Listed Company Manual based on the new revised definition. Each will be addressed in turn.

Question 101.01. In this C&DI, the Staff confirmed that a company can be both a "smaller reporting company" and an "accelerated filer." For example, if an issuer qualifies as both an SRC and an accelerated filer, such issuer may use the scaled disclosure requirements available to SRCs in its annual report on Form 10-K, but as an accelerated filer, it must comply with the accelerated filer deadline and include the Sarbanes-Oxley Section 404 auditor attestation report.

Question 102.02. This C&DI clarified when a reporting company that initially fails to qualify as an SRC may subsequently be eligible for SRC status, assuming that its revenues or public float have sufficiently declined on the annual determination date (for example, in the case of a reporting company with a December 31 fiscal year that failed to meet the amended SRC definition criteria as of June 30, 2018 or thereafter ceases to qualify as an SRC as of a subsequent annual determination date). For these reporting companies to qualify as an SRC, on the last day of the second fiscal quarter of the applicable year, the reporting company must either (i) have a public float of less than $200 million or (ii)(a) "for any threshold that it previously exceeded, [the reporting company] is below the subsequent annual determination threshold (public float of less than $560 million and annual revenues of less than $80 million)" and (b) "for any threshold that it previously met, it remains below the initial determination threshold (public float of less than $700 million or no public float and annual revenues of less than $100 million)." The Staff provided the following example: "A company has a December 31 fiscal year end. Its public float as of June 28, 2019 was $710 million and its annual revenues for the fiscal year ended December 31, 2018 were $90 million. It therefore does not qualify as a smaller reporting company. At the next determination date, June 30, 2020, it will remain unqualified unless it determines that its public float as of June 30, 2020 was less than $560 million and its annual revenues for the fiscal year ended December 31, 2019 remained less than $100 million."

Question 202.01. This C&DI explained that an issuer should include all annual revenues on a consolidated basis when measuring annual revenues for purposes of the definition of SRC.

[21] https://www.sec.gov/news/public-statement/statement-clayton-050919.

[22] https://www.sec.gov/news/public-statement/roisman-statement-proposed-amendments-sox-404b-accelerated-filer-definition.

Question 104.13. This C&DI explained that if an issuer, which could have used reduced SRC disclosure for Part III of its Form 10-K, instead incorporates by reference such information from its proxy statement pursuant to General Instruction G(3), the issuer may still rely on the scaled SRC disclosure in the proxy statement, even if such issuer would not qualify as an SRC in the year in which the proxy statement is to be filed.

PART IV – RULE 701 AMENDMENTS

On July 18, 2018, the SEC adopted amendments to Rule 701 of the Securities Act as mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act. Generally, the Securities Act requires that any offer or sale of securities is either (i) registered under the Securities Act or (ii) made pursuant to an applicable exemption from the registration requirements. Since its adoption in 1988, Rule 701 has been a frequently used exemption by non-reporting companies to issue compensatory equity awards to its employees (and other covered persons) without needing to register the issuance.

Specifically, non-reporting companies can use Rule 701 to issue, during any 12-month period, securities to its employees without being subjected to the Securities Act's enhanced disclosure requirements, provided that the securities are issued pursuant to a written compensatory plan (*e.g.*, an employment agreement). However, prior to the Rule 701 amendments, non-reporting companies limited potential offerings to avoid surpassing a $5 million threshold that imposed enhanced and burdensome disclosure requirements. The Rule 701 amendments seek to alleviate some of those burdens.

Among other things, the Rule 701 amendments increased the threshold amount from $5 million to $10 million for aggregate sales price or amount of securities issued during any consecutive 12-month period in excess of which an issuer is required to deliver to employees and other covered persons certain disclosures. Moreover, issuers that have commenced an offering in a current 12-month period can apply the new $10 million disclosure threshold immediately. The increased threshold amount under the Rule 701 amendments should have a meaningful impact on how non-reporting companies elect to compensate their employees or other service providers. This increased flexibility alleviates the burden imposed on non-reporting companies, while also increasing the likelihood that such companies will issue equity-based compensation to its employees or other covered persons. And as further discussed in Part V below, the SEC also sought public comment on ways to further modernize Rule 701.

PART V – PENDING REQUESTS FOR COMMENTS

Compensation Related Offerings

On July 18, 2018, the SEC published Release No. 33-10521 seeking public comment on ways to modernize Rule 701 and the relationship between it and Form S-8, in light of the changing economy and evolving work arrangements. In part, the SEC stated "[s]ignificant evolution has taken place both in the types of compensatory offerings issuers make and the composition of the workforce" since the SEC's last substantive amendments in 1999. Specifically, the SEC sought public comment on whether Rule 701 should be further revised, including (i) a better understanding of how Rule 701 might apply in the "gig economy"; (ii) whether changes to Rule 701 and Form S-8 should be coordinated; and (iii) if extending Rule 701 to reporting companies may eliminate the need for Form S-8 registration. The official comment period closed on September 24, 2018.

Quarterly Reporting

On December 18, 2018, the SEC published a request for public comment on earnings releases and quarterly reports.[23] The request was issued the day before, and in place of, the SEC's previously scheduled "Sunshine Act Meeting" (a meeting open to the public) to consider whether to issue such a request, and the request sought feedback as to how the SEC could reduce the burden on public companies associated with quarterly reporting, while preserving the informational needs of investors. More recently, the SEC held a roundtable discussion in July to further discuss "the impact of short-termism on our capital markets and whether our reporting system, or other aspects of our regulations, should be addressed to modify these concerns."[24]

The idea of moving from quarterly to semi-annual reporting is neither novel nor outrageous. In fact, both the European Union and United Kingdom have eliminated the requirement for quarterly reporting. Eliminating the requirement, however, does not automatically trigger change. For example, the U.K. eliminated the quarterly reporting requirement in 2014, but only a small minority of U.K. companies have made the switch to semi-annual reporting.

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[23] *See* Release Nos. 33-10588 and 34-84842.

[24] Press Release, https://www.sec.gov/news/public-statement/clayton-announcement-short-long-term-management-roundtable.

In April 2016, the SEC collected comments on the frequency of periodic reporting and the reporting process generally in connection with its concept release on the business and financial disclosure requirements of Reg. S-K. More recently, in August 2018, the topic of quarterly reporting by public companies gained widespread attention when President Trump tweeted that he had asked the SEC to study the possibility of changing the reporting requirements for public companies from quarterly to semi-annually. Speaking at the Financial Executives International conference in November 2018, Chairman Clayton said that the SEC had been considering the matter even before the President brought up the idea in August.

In a speech at the Bipartisan Policy Center in October 2018, Chairman Clayton said that the quarterly report is driven by investor demand, and he pointed out that even in countries that do not have a quarterly reporting requirement, companies will still produce the information. He also observed that while the quarterly report does play a role in driving short-term thinking, it is not the only factor. In addition, it is important to note that in light of requirements under the Securities Act and the demand of underwriters and investors, quarterly reporting may continue to be essential for any company that wants to access the capital markets quickly. Therefore, even if the SEC decides to eliminate a requirement for quarterly reporting, the practice will likely continue, but perhaps with only the substance that investors and reporting companies consider the most meaningful. Alternatively, Chairman Clayton has expressed an interest "in exploring whether the information typically included by companies in earnings releases could be allowed to satisfy certain quarterly reporting obligations and whether there are ways that quarterly disclosures could be streamlined."[25]

Private Offering Exemptions

On June 18, 2019, the SEC announced that it is also seeking comment on "possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections."[26] The Securities Act is a multifaceted system and can be particularly difficult to navigate, especially for small businesses and other emerging companies. However, despite this complicated regulatory framework, the private capital markets have continued to flourish, raising approximately $2.9 trillion in 2018 (nearly double the $1.5 trillion that was raised in the public markets). But as the number and size of private offerings has continued to grow, so too has the need for clear and streamlined guidelines for the registration exemptions.

The SEC has requested feedback on, among other things, whether: (i) the current framework, as a whole, is consistent, accessible, and effective, or whether the SEC should consider changes to simplify it; (ii) changes should be made to streamline specific capital-raising exemptions; (iii) there may be gaps that make it difficult to rely on a particular exemption to raise capital at key stages of a company's business cycle; (iv) that limitations on who can invest in certain exempt offerings (or the amount they can invest) provide adequate investor protection; (v) the SEC should take steps to facilitate capital formation in exempt offerings through pooled investment funds (*e.g.*, whether retail investors should be allowed greater exposure to EGCs); and (iv) the SEC should revise its rules governing exemptions for resales of securities to facilitate capital formation and to promote investor protection by improving secondary market liquidity. The SEC is also soliciting feedback on the complexities surrounding the integration doctrine and its related safe harbors, as well as whether the "Accredited Investor" definition should consider qualities beyond the current "income standard" (*e.g.*, investor sophistication).

Chairman Clayton has emphasized that the SEC's efforts to simplify access to offering exemptions are consistent with the SEC's overall priorities to ensure that capital-raising is rational, accessible, and effective. Indeed, "our capital markets would benefit from a comprehensive review of the design and scope of our framework for offerings that are exempt from registration."[27] Based on this request and any potential rule-making that may follow, it appears that the SEC is focused on streamlining the exempt offering process without losing sight of investor protection.

PART VI – LEGISLATIVE DEVELOPMENTS

Over the last few years, Congress has taken action to lessen the regulatory burden of being a public company and promote capital raising in the United States. Some of these actions have a direct impact, some have mandated new regulations by the SEC, and some have

[25] Release, https://www.sec.gov/news/public-statement/clayton-announcement-short-long-term-management-roundtable#_ftn1.

[26] Concept Release, https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[27] Concept Release, https://www.sec.gov/rules/concept/2019/33-10649.pdf.

been more aspirational. For example, on July 17, 2018, the House of Representatives passed, by a vote of 406-4, bipartisan financial reform legislation titled the "JOBS and Investor Confidence Act of 2018" (commonly referred to as "JOBS Act 3.0"). In part, JOBS Act 3.0 was intended to build upon the 2012 Jumpstart Our Business Act and on the FAST Act. Despite its overwhelming support, JOBS Act 3.0 stalled and never made it out of the Senate. To date, however, similar bills have since been introduced in the Senate or the House. While it is not likely all of these proposed bills will become law, they demonstrate a common theme in which our federal government is supportive of both appropriate securities regulation and robust capital markets.

Encouraging Public Offerings Act of 2019 (S. 536)

This bill, sponsored by Thom Tillis (R-NC) and introduced to the Senate in February 2019, would permit all issuers to engage in "test-the-waters" activities with qualified institutional buyers and other institutional accredited investors in the IPO process to gauge accredited and institutional investor interest in a securities offering.[28] Specifically, all companies could submit confidential draft registration statements for a proposed IPO, or subsequent securities offerings within one year thereafter, for SEC review and feedback. Currently, the Securities Act permits an EGC to confidentially submit a registration statement in connection with its IPO and to engage in "test-the-waters" activities in connection with its securities offerings, although in February 2019, the SEC proposed a new rule that would allow all issuers to engage in "test-the-waters" activities.[29]

Main Street Growth Act (H.R. 2899)

Introduced in the House in May 2019 by Tom Emmer (R-MN), this bill would amend the Exchange Act to allow for the registration of a new form of exchange (commonly referred to as a "venture exchange") with the SEC to provide trading venues more appropriately tailored to the needs of small and emerging companies.[30] Securities of "early-stage growth companies" exempt from registration pursuant to Regulation A+, securities of EGCs, and securities of certain other smaller issuers that are registered under Section 12(b) of the Exchange Act would be eligible for trading on a venture exchange. Securities traded on a venture exchange would not be permitted to trade on a national securities exchange during any period in which the venture security is traded on a venture exchange. However, if passed, these new venture exchanges would permit qualifying companies to more readily trade their securities, providing for increased liquidity in the private investment industry.

Improving Investment Research for Small and Emerging Issuers (H.R. 2919)

Sponsored by Rep. Bill Huizenga (R-MI) and introduced in the House in May 2019, this bill would require the SEC to carry out a study to evaluate the issues affecting the provision of and reliance upon investment research into small issuers and pre-IPO companies, including emerging growth companies and other small issuers.[31] The study would be required to examine, among other topics, (i) factors related to the demand for such research by institutional and retail investors; (ii) the availability of such research (including the number and types of firms that provide such research); (iii) conflicts of interest relating to the production and distribution of investment research; (iv) the costs of such research; (v) the impacts of different payment mechanisms for investment research; (vi) any unique challenges faced by minority-owned, women-owned, and veteran-owned small issuers in obtaining research coverage; and (vii) the impact on availability of research coverage of broker and dealer concentration and consolidations, SEC rules, registered national securities association rules, federal and state liability concerns, and the 2003 Global Analyst Research Settlement. The SEC's report would be required to provide recommendations to increase the demand for, volume of, and quality of investment research into small issuers, including EGCs and companies considering IPOs.

Fostering Innovation Act of 2019 (S. 452)

Introduced in the Senate in February 2019 by Rep. Thom Tillis (R-NC), this bill would amend Section 404(b) of the Sarbanes-Oxley Act to provide a temporary exemption for certain low-revenue emerging growth companies from the SOX 404(b) auditor attestation requirement, and for those companies that would otherwise lose their exempt status at the end of

[28] https://www.congress.gov/bill/116th-congress/senate-bill/536/text.

[29] Press Release, https://www.sec.gov/news/press-release/2019-14.

[30] https://www.congress.gov/bill/116th-congress/house-bill/2899/text.

[31] https://www.congress.gov/bill/116th-congress/house-bill/2919/text.

the five-year EGC period under current law.[32] The temporary exemption is reserved for low-revenue issuers that (i) ceased to be an EGC on the last day of the fiscal year of the issuer following the fifth anniversary of its IPO, (ii) had average annual gross revenues below $50 million as of the most recently completed fiscal year, and (iii) are not large accelerated filers.

Promoting Transparent Standards for Corporate Insiders Act (H.R. 624)

Sponsored by Rep. Maxine Waters (D-CA), this bill would require the SEC to consider certain types of amendments to Rule 10b5-1 to ensure that corporate insiders are not able to indirectly engage in illegal insider trading.[33] Among other things, this would include: (i) imposing additional limitations on the ability of corporate insiders to adopt Rule 10b5-1 trading plans; (ii) limiting insiders from adopting multiple, overlapping Rule 10b5-1 trading plans; (iii) imposing a mandatory delay between the adoption of a qualifying plan and the first trade under such plan; (iv) limiting the frequency with which issuers and insiders can modify or cancel a plan; (v) requiring that SEC filings be made with respect to trading plan adoptions, amendments, terminations, and transactions; and (vi) requiring boards of issuers to adopt policies covering Rule 10b5-1 trading plan practices. In January 2019, the House approved this bill by a vote of 413-3. It will now be passed to the Senate for further action.

Helping Angels Lead Our Startups (HALOS) Act (H.R. 1909)

Rep. Steve Chabot (R-OH) introduced this bill in the House in March 2019.[34] Specifically, this bill directs the SEC to revise Regulation D to give startups a better chance to market to interested parties without violating securities laws. In particular, the bill requires a revision to the prohibition against general solicitation or advertising for certain presentations to "angel investor groups," colleges and universities, nonprofit organizations, and venture capital associations, provided that the issuer adheres to certain conditions of communications. Among other things, the issuer would not be permitted to make investment recommendations or provide advice to attendees, take any active role in the negotiations between the presenting issuer and any attendees, or receive any compensation that would require the sponsor to register as a broker/dealer.

Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2019 (H.R. 609)

Introduced in the House by Rep. Bill Huizenga (R-MI) in January 2019, this bill would alleviate costs to small business owners by providing an exemption from Exchange Act registration for mergers and acquisition brokers who help transfer the ownership of smaller, privately held companies — privately held companies that meet either or both of (i) earnings before interest, taxes depreciation, and amortization less than $25 million or (ii) gross revenues below $250 million.[35]

Expanding Access to Capital for Rural Job Creators Act (H.R. 2409)

Introduced in the House by Cynthia Axne (D-IA) in April 2019, this bill would require the SEC's Advocate for Small Business Capital Formation to identify any unique challenges to rural area small businesses when identifying problems that small businesses have with securing access to capital.[36]

CONCLUSION

In conclusion, the SEC has taken many steps to promote capital formation, while also simplifying disclosure requirements for both public and private issuers. Congress has similarly been a supportive facilitator of simplifying disclosure obligations and promoting capital formation in the United States. We expect additional developments towards this goal, in part because the current SEC is "committed to efforts that equally serve the neighborhood coffee shop that is looking to expand into a second location, the biotech startup looking to hire more scientists to cure cancer, the social media company looking to conduct its IPO, and the Main Street investor saving for their future."[37] ■

[32] https://www.congress.gov/bill/116th-congress/house-bill/2919/text.

[33] https://www.congress.gov/bill/116th-congress/house-bill/624/actions.

[34] https://www.congress.gov/bill/116th-congress/house-bill/1909/actions.

[35] https://www.congress.gov/bill/116th-congress/house-bill/609.

[36] https://www.congress.gov/bill/116th-congress/house-bill/2409.

[37] Jay Clayton, *Remarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival*, *available at* https://www.sec.gov/news/speech/speech-clayton-082918.