



Securities Law Alert

Developments in securities law

A publication of Nixon Peabody LLP

January 7, 2008

SEC eases regulatory burdens for smaller public companies

Following up on two rule proposals published this past summer, the Securities and Exchange Commission adopted amendments that will significantly affect the reporting obligations of smaller public companies. With recent amendments to Rule 144,¹ the SEC has taken several steps to provide smaller public companies with greater flexibility to raise capital while increasing the number of registrants eligible to provide scaled disclosure formerly available only to small business issuers.

SEC adopts rules easing restrictions on use of Form S-3 by smaller public companies

The SEC adopted rules that will greatly expand the number of companies eligible to use Form S-3 for primary offerings. Under the new rules,² registrants other than shell companies will be able to use Form S-3 for primary equity and debt offerings of securities, including shelf offerings, as long as the offerings stay within the size limitations imposed and satisfy the other eligibility requirements of the form. Under the prior rules, companies with less than \$75 million in public float were ineligible to use Form S-3 for primary offerings, and had to rely upon Form S-1, which has certain disadvantages as compared to Form S-3, such as prohibiting the use of forward incorporation by reference. These rules will go into effect on January 28, 2008.

New rules

The rules will add a new instruction to Form S-3 (Instruction I.B.6.) allowing companies with less than \$75 million in public float to register primary offerings on this form, provided that they:

1. have a class of securities registered under Sections 12(g) or 12(b) of the Exchange Act or are required to file reports under Section 15(d) and have filed all reports required under these sections on a timely basis for the past 12 months;
2. have a class of common equity that is listed or registered on a national securities exchange;

¹ See our *Securities Law Alert* located at http://www.nixonpeabody.com/linked_media/publications/Securities%20Law%20Alert_01%2004%202008.pdf.

² See SEC Release No. 33-8878, located at <http://www.sec.gov/rules/final/2007/33-8878.pdf>.

3. are not shell companies and have not been shell companies for the past 12 months; and
4. have not sold more than one-third of their public float in primary offerings using Instruction I.B.6. to Form S-3 over the previous 12 calendar-month period.

The final rules differ slightly from the proposals, by permitting companies to sell up to one-third of their public float in securities, rather than the proposed 20 percent. This benefit is tempered by the additional requirement included in the final rules that the securities sold must be listed on a national securities exchange, essentially prohibiting this use of Form S-3 by companies listed on the OTC Bulletin Board or in the Pink Sheets.

Calculating public float

One notable aspect of the new rules is the timing and manner in which a registrant with less than \$75 million in public float must calculate the amount of securities it may sell on Form S-3. This amount is calculated using a two-step process and was adopted largely as proposed. First, the registrant must calculate its public float. In calculating the price used to determine the company's public float, companies will first be required to look at the price at which their shares were last sold, or the average bid and asked prices for the common equity as of a date within 60 days before the date of sale. A registrant will then aggregate all sales from both equity and debt offerings made pursuant to this new rule over the prior 12 calendar months and determine whether the one-third limit has been exceeded. For convertible debt offerings, registrants would look to the value of the underlying equity shares, rather than the market value of the debt. If the one-third limit has not been exceeded, then registrants would be able to sell securities with a value representing the difference between (i) one-third of its public float and (ii) the securities sold in the prior 12 calendar months under this rule.

Because the public float calculation would be performed immediately before the intended sale, regardless of when the Form S-3 was filed, issuers could have added flexibility in offering securities under these rules. For instance, a registrant's public float may increase between filing and takedown from a shelf, allowing the issuer to sell more securities on the Form S-3 than when originally filed. Additionally, because companies will look back 12 calendar months from the time of the intended sale in calculating the amount of securities they may sell, offerings that occurred more than 12 calendar months ago will not be included in this calculation, and will not restrict current sales. However, companies should be aware that, under the new rule, if their public float declines over time, they may be precluded from selling additional securities if they exceed the one-third limit at the time of the intended offering. Importantly, a reduction in a registrant's public float will not invalidate prior sales, because the relevant point for determining whether the one-third threshold has been exceeded is at the time of sale.

The SEC makes clear that registrants meeting the \$75-million public float threshold at the time of filing a Form S-3 will not be penalized for falling below that figure after the effective date of the registration statement, or be otherwise restricted on the amount of securities they may sell. Such registrants, however, would have to recalculate their public float with each Section 10(a)(3) update to the Form S-3, at which point, it will be determined whether the one-third restriction should be imposed. Also adopted as proposed is the instruction for Form S-3 that will permit companies relying on the new rule whose public float exceeds \$75 million after filing the Form S-3 to have unrestricted use of Form S-3 for primary offerings, without regard to the one-third limit.

These new rules make similar changes to Form F-3, used by foreign private issuers to register securities offerings.

SEC adopts rules eliminating regulation S-B and moving scaled disclosure requirements to regulation S-K

The SEC adopted rules³ that will significantly affect smaller public companies by making two principal changes. First, the new rules eliminate Regulation S-B, and move the disclosure traditionally found in Regulation S-B into a scaled disclosure format within Regulation S-K and Regulation S-X. Second, the new rules expand the group of registrants that will be eligible to use these rules by creating a new category known as “smaller reporting companies,” essentially combining companies previously known as “small business issuers” with those known as “non-accelerated filers.”

Under the new rules, which go into effect on February 4, 2008, small business issuers filing their next annual reports for a fiscal year ending on or after December 15, 2007, may use either Form 10-KSB as had traditionally been used, or Form 10-K, with the option of using the new scaled disclosure requirements in Regulation S-K instead of full Regulation S-K disclosure. After that annual report has been filed, small business issuers will be required to use Form 10-Q and 10-K for quarterly and annual reports and may again opt for the new scaled Regulation S-K disclosure. Companies that qualify for the first time as “smaller reporting companies,” under the new definition, will have the option of using the scaled disclosure requirements in Regulation S-K when filing their next periodic reports after February 4, 2008.

Determining status as a “smaller reporting company”

As adopted, the new rules permit registrants meeting the definition of a “smaller reporting company” to use the less-burdensome, scaled disclosure in Regulation S-K. To qualify, companies must have shares of common equity held by non-affiliates, or public float, of less than \$75 million. Companies would calculate their public float using one of the methods set forth below:

- **Reporting companies:** Reporting companies multiply the number of shares of common equity held by non-affiliates by the price at which its shares were last sold or the average of the bid and asked prices as of the last day of the second fiscal quarter.⁴
- **Non-reporting companies filing IPOs:** Non-reporting companies filing IPOs will determine their public float by adding the number of shares being registered in the public offering to the number of outstanding shares held by non-affiliates. This figure will be multiplied by the estimated offering price per share in the IPO to determine the company’s public float. Registrants also may recalculate this figure using the actual offering price and number of shares sold in the IPO.
- **Non-reporting companies filing Exchange Act registration statements:** A company filing a Form 10 registration statement will calculate its public float similarly to the calculation performed by reporting companies, but will use a price as of a date within a 30-day period before the filing of the registration statement.

³ See SEC Release No. 33-8876, located at <http://www.sec.gov/rules/final/2007/33-8876.pdf>.

⁴ This determination date is the same as that used to determine accelerated filer status under Rule 12b-2.

- **Alternative revenue test:** If a registrant is unable to calculate its public float using the above tests, the company would qualify as a smaller reporting company if it had less than \$50 million in revenues in the last fiscal year.

In a measure of regulatory flexibility, the new rules allow smaller reporting companies who determine, at the end of their second quarters, that they now qualify as larger reporting companies to comply with the larger company disclosure requirements in the first quarterly report in the fiscal year following the fiscal year of the determination date. Conversely, larger public companies that determine, at the end of their second quarters, that they now qualify as smaller reporting companies may opt to provide scaled disclosure, beginning with the Form 10-Q covering that second fiscal quarter.

Other important elements and transition issues

The new rules permit smaller reporting companies to choose whether they wish to comply with the scaled disclosure requirements (former Regulation S-B items) or the regular and more rigorous Regulation S-K requirements on an item-by-item basis.⁵ When providing such à la carte disclosures, smaller reporting companies should note that it is important that disclosures from one period to the next be consistent to allow investors to make accurate period-to-period comparisons.

The biggest change for current small business issuers under the new rules may be the elimination of Regulation S-B and the placement of this information within separate paragraphs in the more detailed Regulation S-K. The new rules also eliminate the SB reporting forms (e.g., Forms 10-KSB, 10-QSB, and SB-2). To ease the transition, Regulation S-K will have an index identifying the scaled disclosure items available to smaller public companies in the beginning of Regulation S-K. In addition, the Division of Corporation Finance plans to provide an informational brochure to registrants to assist with common transition questions.

⁵ The exception to this is Item 404 of Regulation S-K, where smaller reporting companies will have to comply with the more rigorous requirements contained in the scaled disclosure provisions (formerly in Regulation S-B) of this item.

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