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Recent Developments Concerning Small Public Companies

Dear Clients and Friends,

In this issue we highlight recent significant developments in the reporting requirements for small public companies. We are also including a discussion about recent rulings from the Internal Revenue Service that reverse the IRS's position on the tax deductibility of certain severance payments under IRS Code Section 162(m).

NEW "SMALLER REPORTING COMPANY" DISCLOSURE REQUIREMENTS

General

On December 19, 2007, the Securities and Exchange Commission issued final rules amending and streamlining the reporting requirements for small public companies. The new rules were effective February 4, 2008 and:

1. create a new category of filer, the "smaller reporting company," which replaces the current "small business issuer" category;

2. expand the availability of scaled disclosure requirements to filers with a public float of less than $75 million (or where no public float or market price exists, less than $50 million in annual revenue)[1];

3. move the Regulation S-B reporting requirements to Regulation S-K and eliminate Regulation S-B and its various reporting forms, for example Form SB-2;

1 The previous threshold to qualify as a small business issuer was a public float of less than $25 million.

4. allow small reporting companies to choose the scaled reporting requirements on an à la carte basis; and

5. allow foreign companies to file as a smaller reporting company.

The SEC estimates that an additional 1,600 companies will qualify as smaller reporting companies, versus the number of existing small business issuers.

Definition of Smaller Reporting Company & Determination of Public Float

In order to qualify as an eligible smaller reporting company, a company cannot be an investment company or asset-backed issuer and

- must have a public float of less than $75 million; or

- have annual revenues of less than $50 million (if there is no public float or market price).

A reporting company will determine its public float under the existing date guidelines set forth in Rule 12b-2 of the Exchange Act. That is, public float is determined on the last business day of the second quarter. Non-reporting companies will calculate their public float based on their choice of a date within 30 days of the filing date of their initial registration statement.

Elimination of Regulation S-B and SB Forms

The amendments eliminate Regulation S-B and the "small business issuer" designation and move the disclosure requirements for smaller reporting companies to Regulation S-K. Although the existing reporting requirements are largely unchanged, they are now set forth in separate paragraphs within Regulation S-K. The definition of smaller reporting company will include an index of the location of the new scaled Regulation S-K disclosure items. Thus, all non-financial disclosure requirements are now contained in a single location.

The amendments also eliminate all SB forms. Smaller reporting companies will now file, for example, Forms 10-K, 10-Q, S-1 and, as discussed below, S-3, each subject to the scaled disclosure requirements.

Smaller reporting companies are allowed to choose on an item-by-item basis (i.e., à la carte) whether to disclose information under the abbreviated scaled disclosure or the requirements that larger companies follow. Smaller public companies should be aware, however, that there is one exception to the à la carte rule. If the scaled disclosure requirements are more rigorous, the smaller reporting company must follow the more rigorous requirement.[2]

Although the forms under Regulation S-K are very similar to the forms under Regulation S-B, companies will notice several differences when they begin to prepare the new forms. Most notably, the financial statement requirements previously located in Item 310 of Regulation S-B are now contained in a new Article 8 of Regulation S-X and the financial statement requirements for "smaller reporting companies" require two years of comparative audited balance sheet data, rather than one year under Regulation S-B. Further, the item numbering in the forms used under Regulation S-K may be different depending on the form used.

2 The SEC stated that at present, the only smaller reporting company disclosure requirement that is more rigorous is Item 404. Under Item 404, smaller reporting companies must report related person transactions that exceed the lesser of $120,000 or 1% of the company's total assets at the end of the last two completed fiscal years. In contrast, a larger company must report only those related person transactions that exceed $120,000.

Entering and Exiting Smaller Company Status

The amendments include favorable rules for entering and exiting smaller reporting company status. For example,

- a larger reporting company that determines it is a smaller reporting company as of the last day of its most recently completed second quarter is permitted to file as a smaller reporting company starting with that quarter; conversely,
- a smaller reporting company that is required to transition to larger reporting company status after its determination date (i.e., the last business day of its second quarter) is not required to transition until the first quarter of the following year (in other words, the company would remain eligible to file as a smaller reporting company for its Form 10-K for that year).

Phase-in Period

Companies that currently qualify as a "small business issuer" under Regulation S-B have the option to file their next annual report for a fiscal year ending on or after December 15, 2007 on Form 10-KSB, using Regulation S-B. After a "small business issuer" files that next annual report, it will then be required to file quarterly reports on Form 10-Q and annual reports on Form 10-K. Alternatively, companies that qualify as "smaller reporting companies" have the option to use the new scaled Regulation S-K requirements when filing their next periodic report due after February 4, 2008.

Foreign Companies

The amendments also make the smaller reporting company designation available for foreign companies. Regulation S-B only made the small business issuer designation available to US and Canadian issuers. However, foreign companies whose public float would qualify them as a smaller reporting company must use Form S-3 instead of Form F-3 if they want to file as a smaller reporting company. This could be a significant difference because in such a situation, the foreign company would be required to prepare its financial statements in accordance with US GAAP.

FORM S-3 ELIGIBILITY

On December 19, 2007, the SEC issued its final rules amending the eligibility requirements for Forms S-3 and F-3 to permit domestic and foreign issuers to conduct primary securities offerings on these forms without regard to the size of their public float or the rating of the debt they are offering. The new rules were effective January 28, 2008.

In order for a registrant to use the revised Forms S-3 and F-3, the registrant must meet Form S-3's existing general eligibility requirements (e.g., is currently making public filings and has, in a timely manner, made all filings within the prior 12 months) and its transaction requirements. However, the new rules provide for a new transaction requirement category. The new category provides that a registrant with a public float of less than $75 million may register a primary offering of its securities on Form S-3 or Form F-3 if it:

1. has a class of common equity securities listed and registered on a "national securities exchange";[3]

2. does not sell more than the equivalent of 1/3 of its public float in primary offerings in any 12 calendar month period;[4] and

3 A "national securities exchange" includes, among others, the NYSE, the American Stock Exchange, and Nasdaq, but does not include OTCBB or Pink Sheet issuers.

4 Note that a company's public float may increase because of an increase in its stock price or because it raises capital in equity offerings. If company's the public float rises, its 1/3 threshold will also rise.

3. is not a “shell company” and has not been a “shell company” for at least 12 calendar months immediately preceding the filing of the registration statement.

The new rules are intended to allow more companies to benefit from the greater flexibility and efficiency afforded by Forms S-3 and F-3. For example, “smaller reporting companies” will now be permitted to incorporate reports previously and subsequently filed under the Securities Exchange Act of 1934 by reference and may register securities in primary offerings in advance of any intended sale so that they may raise funds when needed or sell the securities when market conditions are favorable.

PROPOSED EXTENSION OF DEADLINE FOR AUDITOR ATTESTATION REPORT (AGAIN)

On February 1, 2008, the SEC issued a proposed amendment to the temporary rules it issued on December 15, 2006. The temporary rules required non-accelerated filers to include an attestation report of their independent auditor on internal controls for fiscal years ending on or after December 15, 2008, in their annual report pursuant to the requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002. Under the proposed amendments, a non-accelerated filer would now not be required to provide the auditor’s attestation report until fiscal years ending on or after December 15, 2009. As a result, if the proposed amendments are adopted, all non-accelerated filers would be required to:

1. complete management’s report on internal controls for fiscal years ending after December 15, 2007; and

2. provide the auditor’s attestation report in the annual report filed for fiscal years ending on or after December 15, 2009.

IRS REVERSES POSITION ON CERTAIN PERFORMANCE-BASED COMPENSATION UNDER 162(m)

In an unexpected move, the IRS recently reversed its position regarding whether compensation paid to a public company executive upon a termination without cause, or for good reason, qualifies for the “performance-based compensation” exception to the $1 million deduction limit under Section 162(m) of the Internal Revenue Code.

Background

Under Section 162(m), annual compensation paid to a public company CEO and the other three highest paid executives (other than the CFO) in excess of $1 million is not deductible unless it is performance-based. Generally, compensation is performance-based if awarded under a shareholder approved plan and paid solely on account of the attainment of one or more performance goals. If, under the terms of the plan or agreement, the compensation could be paid regardless of whether the performance goals are met, no awards under the plan or agreement would qualify for the performance-based compensation exception.

Under the Section 162(m) regulations, the fact that an award is payable earlier on account of death, disability or change in ownership or control does not prevent the award from being performance-based, but it will not be performance-based if the award is actually paid under those specific circumstances. Earlier PLRs extended this exception in situations where a payment is made to an executive on account of his or her termination of employment without cause, for good reason or upon retirement. And, although private rulings cannot be relied on by anyone except the taxpayer to whom the ruling is issued, they are viewed generally as an indication as to the IRS’ position in similar factual situations.

The IRS Reverses its Position in PLR 200804004

The IRS held that a provision in an executive's employment agreement permitting performance shares or performance units to be paid on account of the executive's termination without cause or for good reason did not qualify for the performance-based exception under Section 162(m). That conclusion held true even if the executive remained employed and satisfied all the performance goals.

Without discussing its prior contrary holdings, the IRS based its position on the Section 162(m) regulations, which specifically provide that an award will not qualify as performance-based "if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained."

Subsequent IRS Guidance and What Companies Should Do as a Result

As the result of an uproar in the benefits community, on February 21, 2008, the IRS issued formal guidance.

Like the private letter ruling, in Rev. Rul. 2008-13 the IRS concludes that compensation will not qualify for the performance-based pay exception if it is payable, regardless of whether the performance criteria is actually met, if the employee is terminated without cause or quits for good reason. In addition, Rev. Rul. 2008-13 states that the performance-based pay exception is unavailable, again regardless of whether the performance criteria is actually met, if an employee is entitled to receive the payments upon retirement.

Fortunately, in Rev. Rul. 2008-13 the IRS postpones the effective date of this ruling. Essentially, the ruling will not be applied to compensation paid under a plan, agreement or contract if the performance period begins on or before January 1, 2009. The ruling also will not be applied if the underlying compensation is paid in accordance with an employment agreement in effect on February 21, 2008. Although the transition period will be helpful, it may not be as long as it sounds. The primary factor is that in determining whether an employment agreement was in effect on February 21, 2008, you must disregard future extensions or renewals, including those occurring automatically under the agreement. Accordingly, companies should now be evaluating and discussing with their advisors the potential impact of the ruling. For new awards intended to qualify as performance-based, a company should consider eliminating or modifying provisions permitting payments in circumstances other than death, disability or change in ownership or control regardless of whether performance goals are met.

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