Cooley

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On April 5, 2012, President Obama signed into law the ***Jumpstart Our Business Startups Act***, which goes by the deft acronym of the "JOBS" Act. As its stated purpose, the Act is designed to increase job creation and economic growth by improving access to the public capital markets for emerging growth companies. Whether it will accomplish that goal remains to be seen.

Passed on a bipartisan basis by overwhelming votes in the House and Senate, the Act seeks to adjust the balance between facilitating capital formation, on the one hand, and attempting to protect investors from the unscrupulous, on the other. To that end, the Act seeks to remove impediments to capital raising for "emerging" public companies by relaxing disclosure, governance and accounting requirements, easing the restrictions on analyst communications and analyst participation in the public offering process, and permitting companies to "test the waters" for public offerings. We note that the Act, while significantly easing the requirements for going public and being public, also includes provisions designed to allow some private companies to defer going public, including provisions raising the threshold for registration under the Securities Exchange Act of 1934, eliminating some of the restrictions on general solicitation in connection with private placements and providing other exemptions from registration under the Securities Act of 1933, such as exemptions for crowdfunding and an expanded Regulation A exemption.

Despite its bipartisan popularity, the JOBS Act has not been without controversy. To its advocates, the Act broadly targets some of the regulatory obstructions that, following the near collapse of the financial system in 2008, are perceived to have stymied small business development and placed a stranglehold on economic growth. The Act also takes steps to promote IPOs in general, and its advocates cite studies showing significant job growth following the typical IPO. Whether those jobs would have been created even if the company had remained private is unclear, the Act's critics counter. Critics of the Act also charge that it will eviscerate long-standing investor safeguards and roll back important transparency and governance requirements. To some of these critics, rather than promoting capital formation, the Act is no more than a leavening agent for half-baked schemes and should more appropriately be styled as "the boiler room legalization act" or the "bucket-shop and penny-stock fraud reauthorization act of 2012."

This *Alert* summarizes key provisions of the Act that address going public and being public:

- IPO on-ramp for "emerging growth companies"
- Communications with analysts
- Testing the waters
- Exchange Act registration threshold
- Changes to Regulation D

This *Alert* also includes observations and commentary regarding the potential impact of this new legislation. A discussion of the new crowdfunding and Regulation A exemptions, as well as other provisions of the Act, is included in a separate *Alert* from our Emerging Companies Group, ***The JOBS Act (Jumpstart Our Business Startups Act) - What Does It Mean for Entrepreneurs?***

IPO "On-Ramp" for Emerging Growth Companies

Definition of Emerging Growth Company

The JOBS Act creates a new category of issuer, the "emerging growth company," that will be able to take advantage of new scaled

disclosure, governance and accounting requirements. As defined in the Act, an "emerging growth company" (EGC) is an issuer that, for its most recently completed fiscal year, had total annual gross revenues of less than $1 billion. An issuer's status as an EGC will then continue until the earliest to occur of any of the following:

- the last day of the issuer's fiscal year during which its gross revenues equal or exceed $1 billion;
- the last day of the issuer's fiscal year following the fifth anniversary of its IPO;
- the date on which the issuer has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or
- the date on which the issuer is deemed to be a "large accelerated filer," generally, a company that, as of the end of a fiscal year, has been a reporting company for at least 12 months (and filed at least one Annual Report on Form 10-K) and whose public float at the end of its most recently completed second quarter had an aggregate worldwide market value of $700 million or more.

Importantly, the category of EGCs has only limited retroactivity: no company that first sold equity in its IPO on or prior to December 8, 2011 can qualify as an EGC.

Scaled Disclosure, Governance and Accounting Obligations for EGCs

To address the concern that some companies have been deterred from undertaking IPOs because of regulatory burdens (and associated costs) accompanying public company status, the JOBS Act exempts EGCs from a number of disclosure, governance and accounting requirements, including the following:

- EGCs will not need to solicit say-on-pay or say-on-golden-parachute votes by their shareholders. In addition, they will not need to provide information regarding "internal pay equity" (i.e., the ratio of CEO compensation to the median of compensation for all other employees), a Dodd-Frank requirement that is still awaiting SEC rulemaking.
- With respect to executive compensation disclosure (under Item 402 of Regulation S-K) in registration statements, proxy statements and periodic and other reports, EGCs will be permitted to comply with the scaled disclosure requirements available to "smaller reporting companies" (*i.e.*, companies with a public float of less than $75 million). As a result, among other things, EGCs will not have to provide a Compensation Discussion and Analysis (CD&A) or a discussion regarding the relationship of compensation to risk; will be able to limit the disclosure in their Summary Compensation Tables to information regarding three executive officers, instead of the usual five, covering only two years instead of the usual three; and will have to provide only three of the seven compensation tables otherwise required (the Summary Compensation, Outstanding Equity Awards and Directors' Compensation Tables), substituting limited narrative disclosure for the omitted tables.
- IPO registration statements for EGCs will not be required to include more than two years of audited financial statements, as opposed to the usual requirement to include three years, with a corresponding reduction in their MD&A disclosures. In addition, in any registration statement or periodic or other report, an EGC's presentation of selected financial data, which would otherwise cover data for the preceding five years, may instead commence with the earliest audited period presented in the EGC's IPO registration statement.
- EGCs will not have to comply with any new or revised financial accounting standards unless and until the standard is likewise applicable to private companies (unless they elect, in their first Exchange Act periodic report or registration statement, to comply with financial accounting standards applicable to non-EGCs, in which case, they must comply with all of those standards for as long as they are EGCs). Nor will they have to comply with any rules that may be adopted by the PCAOB requiring mandatory auditor rotation or "enhanced" or supplemented audit reports that would require the auditor to provide additional information or comment about the audit, both concepts that have recently been under consideration by the PCAOB. Adding an exclamation point to the limitation above, the Act expressly precludes the application to EGCs of any additional rules that the PCAOB may adopt, unless the SEC determines that the application of the rule is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."
- EGCs will not need to provide auditor attestation reports in connection with their audits of internal control over financial reporting. Management's annual report on internal control will still be required.

Observations and Commentary

- It has not gone without notice that, with an annual revenue cap set as high as $1 billion, the definition of EGC will enable almost all IPO candidates and a surprisingly significant proportion of future public companies to avoid compliance with a substantial number of burdensome rules for potentially five years post-IPO. Moreover, the SEC is required to index the $1 billion cap for inflation every five years to reflect changes in the Consumer Price Index. Although it is clearly the intent of Congress to shield only newly public companies, the Act will create an enormous disparity between the obligations of companies that went public on or prior to December 8 and those going public thereafter, raising the question of whether a future Congress might be motivated to address potential concerns regarding fairness by providing further relief for an even broader segment of companies.
- Except, as noted above with respect to compliance with new or revised financial accounting standards, EGCs may choose, apparently on an à la carte basis, whether to take advantage of any particular exemption or amendment for EGCs or to comply with the requirements applicable to non-EGCs. The question remains, however, whether market expectations will drive EGCs to largely comply with requirements applicable to non-EGCs. For example, will first tier investment banks, analysts or institutional investors expect to see a full three years of audited financial statements even though only two are legally required? Will principles of good governance along with pressures from shareholders and proxy advisory firms cause EGCs to solicit non-binding shareholder say-on-pay votes even though none is legally required? Notably, the SEC has in the past attempted various dual-track systems designed to alleviate reporting burdens for smaller companies; however, the lack of market acceptance of scaled disclosure and the companies' inherent interest in avoiding a "small company" label has deterred many smaller companies from relying on scaled regulation. Nevertheless, it is possible that the availability of the exemption for companies with almost $1 billion in annual revenues may remove the taint that might otherwise discourage companies from taking full advantage of Act's exemptions and scaled disclosure.
- For the large group of companies that are expected to fall into the category of EGCs in the future, the effect of the Act is to repeal wide swaths of Dodd-Frank, Sarbanes-Oxley and other reform legislation, as well as longstanding public company disclosure requirements. Ironically, many of these "impediments" to capital formation were implemented in the last decade to address perceived failings in regulation identified in the wake of the dot-com bust, the Enron scandal and the most recent financial crisis. As a result, many of the Act's provisions have drawn fire from shareholder advocates concerned that the Act will create conditions that make it easier for malefactors to execute fraudulent schemes. For example, in a letter to Congress, SEC Chair Mary Schapiro expressed apprehension that the category of EGC was "so broad that it would eliminate important protections for investors in even very large companies, including those with up to $1 billion in annual revenue. I am concerned that we lack a clear understanding of the impact that the legislation's exemptions would have on investor protection."
- The effect of eliminating the requirement to have an audit of internal control over financial reporting is to extend to five years the prior two-year on-ramp otherwise applicable to newly public companies. For many companies, expansion of the exemption from the notorious Sarbanes–Oxley section 404(b) will provide welcome relief from the substantial costs and burdens of an internal control audit; however, for "smaller reporting companies," there will not be any added benefit since they were already permanently exempted from the internal control audit requirement by Dodd-Frank in 2010.
- In some areas, the Act is unusually prescriptive, effectively rescinding a number of SEC regulations and wresting from the SEC and, particularly, the PCAOB the ability to develop and adopt rules affecting EGCs. Some have questioned the Act's relatively novel approach of exempting EGCs prospectively from rules that have not yet been, and may never be, adopted. Whether or not this legislation carries an implicit admonition to regulators, it does appear to upset the traditional legislative/regulatory equation and has been criticized by some for undermining the deliberative process and preempting independent standard-setting by regulatory experts.

Facilitating the IPO Process: Relaxing Restrictions on Research Analysts; "Testing the Waters"

The Act contains a number of provisions intended to facilitate the IPO process. Several provisions are designed to foster analyst research coverage of smaller companies, an effort to address the frequent complaint about the difficulty of sustaining coverage for companies that fall under the analysts' radar. The Act also allows IPO candidates to take preliminary steps to determine the potential level of investor interest before committing to the expensive and time-consuming prospectus drafting and SEC review process, and it permits them to start down the SEC review path on a confidential basis so that sensitive information will not necessarily be disclosed should they ultimately decide not to move forward with an offering.

Publication of Analyst Research

To promote research coverage of EGCs, the Act relaxes restrictions on the publication by investment banks of research reports about EGCs before and during a registered offering—whether an IPO or a follow-on offering of common equity. Under prior law, research reports by analysts, especially those participating in an underwriting of securities of the subject issuer, could be deemed to be "offers" of those securities under the Securities Act and, as result, these reports were rarely issued prior to completion of an offering. The Act provides that publication of a research report does not constitute an offer of securities, even if the investment bank that publishes the research is participating or will participate as an underwriter in the offering.

Under the Act, "research" is defined broadly as any information, opinion or recommendation about a company and includes oral as well as written and electronic communications. This research need not be accompanied by a full prospectus and need not provide information "reasonably sufficient upon which to base an investment decision." The research need not even be consistent with the prospectus, if there is one. In other words, research providers are free to say just about anything they wish about an IPO candidate without incurring liability under the Securities Act—limited only by the general anti-fraud rules.

The Act also eliminates existing restrictions on publishing research following an IPO or around the time the IPO lockup expires or is released. Currently, under rules of the Financial Industry Regulatory Authority, or FINRA, and the SEC, underwriters of an IPO cannot publish research for 25 days after the offering (40 days if they served as a manager or co-manager), and managers or co-managers cannot publish research within 15 days prior to or after the release or expiration of the IPO lockup agreements (so-called "booster shot" reports). The Act requires FINRA and the SEC to eliminate these restrictions with respect to EGCs. As a result, any research analyst will be able to publish at any time after an EGC IPO, including immediately after the offering.

The Act also eliminates some of the restrictions currently in place prohibiting interaction between research analysts and investment bankers from the same firm in connection with EGCs' IPOs. Current limitations trace back to the "global settlement" of 2003, in which several key investment banks agreed to these restrictions as part of a settlement of claims arising out of the dot-com bust and other scandals of the period, as well as other rule-making by the SEC, FINRA and the exchanges. The restrictions were designed to address perceived conflicts of interest involving analysts and investment bankers, particularly the perception that bankers sometimes promised their clients favorable research to win underwriting business, while analysts supported their firms' investment banking businesses by issuing favorable research on companies they did not believe in. The Act requires FINRA and the SEC to roll back, in connection with IPOs of EGCs, certain restrictions implicated by the Act. The Act expressly prohibits the SEC and FINRA from adopting or maintaining restrictions on who can arrange communications between a securities analyst and a potential investor, or restrictions on research analysts and investment bankers meeting together with an EGC. To the extent that any similar restrictions apply as a result of the global settlement, a court order may be required to lift the restrictions for those firms that were party to the settlement. Other restrictions will remain in place, such as analyst certification requirements, limitations on compensation practices, prohibitions on analysts helping to solicit investment banking business, prohibitions on banker input into research, and provisions relating to budgeting and oversight of the research function.

Testing the Waters

The Act significantly relaxes current "gun-jumping" restrictions by permitting an EGC, and any person acting on its behalf, to engage in pre-filing communications with qualified institutional buyers, or QIBs, and institutional accredited investors. Under current rules, "well-known seasoned issuers," or WKSIs, can engage in similar testing-the-waters communications, but smaller, less mature public companies and pre-IPO companies cannot. These new "test-the-waters" communications can be oral or written and can be made either before filing a registration statement or after. They can be made in connection with an IPO or any other registered offering. While the permitted communications are limited to those "to determine whether such investors might have an interest in a contemplated securities offering," it is difficult to imagine communications in this context that would not fall within this broad definition. These communications will, however, still be subject to anti-fraud rules.

Confidential IPO Filings

The Act permits EGCs to initiate the IPO process by submitting their IPO registration statements confidentially to the SEC for nonpublic review by the SEC staff. The EGC must, however, make the entire filing public at least 21 days before it commences its road show. This confidential process will allow an EGC to defer the public disclosure of sensitive or competitive information until it is almost ready to market the offering—and potentially to avoid the public disclosure altogether if it ultimately decides not to proceed with the offering. This development follows closely on the heels of a recent SEC action to eliminate the traditional ability of foreign issuers to make their initial IPO filings on a confidential basis. Ironically, the SEC took this action on the theory that there are no longer compelling reasons to treat foreign IPO candidates differently from domestic ones. For EGCs, the Act resolves this inconsistency the opposite way—now both domestic and foreign EGCs will be able to submit their IPO filings on a confidential basis.

Observations and Commentary

- IPO companies will welcome the return to the days when companies could respond to a single track of due diligence that included both investment bankers and research analysts. Current practice, which requires separate due diligence tracks, is cumbersome and time-consuming, and it is questionable whether these separate tracks have produced any demonstrable improvement of investor protection.
- We expect that pre-filing or at least pre-road show meetings with key institutional accounts will become standard IPO practice.
- It is not clear, however, how these test-the-waters meetings—which would constitute "road shows" under current definitions—will interact with the requirement that an EGC make a previously confidential filing public at least 21 days before it commences its road show. Will EGCs effectively need to elect one or the other of these benefits? Apparently, we will need to wait for SEC rule-making to clarify this potential conflict.
- Notwithstanding their new freedom to do so, investment banks may not be rushing to initiate pre-IPO research on EGCs. The Act exempts this research only from being deemed an offer or prospectus under the Securities Act; it does not provide relief from potential liability under anti-fraud provisions. Our sense is that most investment banks will not undertake to publish pre-IPO research, at least until it is clear that other new regulation will not be forthcoming from the SEC, the exchanges or FINRA and the banks have had an opportunity to consider the risks, develop new procedures and become comfortable with the process. As a practical matter, banks that hope to participate in an IPO may be reluctant to publish research before the offering in light of the potential liability they could face under anti-fraud rules.
- The new relaxation of these analyst regulations has not been universally welcomed. SEC Chair Schapiro recently expressed concern that the ability of analysts to publish research prior to an IPO filing and during the registration process may confuse investors and leave them without full protection for misleading information. She noted that the research could "compete" for the attention of potential investors with the company's formal prospectus. But it may take a new Congress before the SEC is willing or able, from a practical perspective, to impose any new restrictions.

Elimination of Prohibition Against General Solicitation and General Advertising for Certain Private Offerings

The Act requires the SEC to amend its rules to permit general solicitation and general advertising in connection with certain private placements under the Securities Act. First, the SEC is required to revise Rule 506 of Regulation D to eliminate the prohibition against general solicitation and general advertising, provided all purchasers are accredited investors. (Rule 506 exempts from registration offers and sales of securities by an issuer to accredited investors and no more than 35 persons who are not accredited investors so long as the other conditions of the rule are satisfied.) Under the amended rules, issuers will need to take reasonable steps to verify that all purchasers are accredited investors using methods determined by the SEC. Previously, general solicitation and general advertising were banned in connection with all private placements. Second, the Act requires the SEC to amend its rules to permit general solicitation and general advertising in offerings designed to trade under Rule 144A, provided that securities are ultimately sold only to persons the seller, and any person acting on its behalf, reasonably believe are QIBs.

Observations and Commentary

- Earlier versions of the Act would have amended Section 4(2) of the Securities Act to remove the ban on general solicitation in

an even broader context. However, that amendment did not survive. As a result, the exception to the ban on general solicitation and general advertising applies only to private placements under Rule 506 solely to accredited investors and not to other types of private placement transactions.

- Elimination of this prohibition means that companies will no longer need to have a "pre-existing relationship" with potential investors. For a public company, this change could affect the way that it undertakes private placements of its publicly traded securities, commonly called "PIPES" transactions, and placements of straight or convertible debt in unregistered offerings designed to trade under Rule 144A. Issuers will have greater flexibility to privately place their securities by engaging in general solicitation through a placement agent or initial purchaser, or directly through personal contacts with potential investors identified as participants in other transactions for companies in similar lines of business or at the same stage of development. So long as the ultimate purchasers are all accredited investors, companies need not have had any prior contact with any potential investor.
- We would not be surprised if these changes to the general solicitation requirements, together with the new provisions permitting companies to "test the waters" in connection with an IPO, encourage more companies to engage in simultaneous public and private offerings under "Black Box" (the SEC no-action letter that first permitted concurrent public and private offerings) or subsequent SEC interpretative guidance. Notwithstanding the latitude provided by the Act to engage in previously prohibited communications, companies will still need to avoid actions that could result in "integration" of these public and private offerings: companies that *sell in a private placement* to institutional investors *originally identified through the public offering process* could still face allegations that these sales constituted "gun-jumping" in connection with the public offering.
- Because SEC rulemaking is required as a predicate, these provisions of the Act will not be effective until the rules are revised.

Increase in Public Company Registration Thresholds

Previously, under the Exchange Act, a company that had more than $10 million in total assets and a class of equity securities "held of record" by 500 or more persons at the end of its fiscal year was required to register under the Exchange Act, effectively becoming a public company subject to corresponding compliance and reporting obligations, whether or not the company was adequately prepared to assume those responsibilities and without any of the financial and other benefits typically associated with an IPO. As a result, as private companies have grown, many have, in effect, been compelled to go public through IPOs before they were otherwise inclined to do so, including some of the most well-known names. The Act amends Section 12(g)(1) of the Exchange Act to raise the threshold for the number of holders of record, measured at the end of a fiscal year, that will trigger registration: now, a company that reaches either 2,000 holders of record or 500 holders of record that are not accredited investors, whichever first occurs, will be required to register under the Exchange Act. In addition, the Act excludes persons from the definition of "held of record" if they hold only securities issued to them pursuant to an employee compensation plan in transactions exempted from the registration requirements of the Securities Act and, as will be specified in rules required to be adopted by the SEC, purchasers of securities acquired pursuant to the "crowdfunding" exemption established by the Act.

Observations and Commentary

- Although the standards for a company to terminate registration or suspend reporting obligations under the Exchange Act were changed for banks and bank holding companies, they were not changed for other issuers. As a result, once a company (other than a bank or bank holding company) has an effective registration statement under the Securities Act or the Exchange Act, its registration may be terminated and its obligation to file reports with the SEC may be suspended only after the class of securities registered with the SEC is held of record by fewer than 300 persons (or fewer than 500 persons if the company has total assets of $10 million or less). As a consequence, the Act will not benefit an existing non-bank public company that wishes to "go dark" from its reporting obligations.
- While the Act requires the SEC to amend its rules to be consistent with the Act, the change in the registration threshold is effected by amendment to the Exchange Act and, as a result, is operative immediately, notwithstanding the absence of new regulation by the SEC (except for the exclusion of crowdfunding investors from the shareholder count). The SEC is required to adopt safe harbor provisions that issuers can follow in determining whether holders of their securities received securities issued pursuant to an employee compensation plan, but that is not a condition to the effectiveness of the exclusion of these holders from the stockholder count.

On the Horizon

The Act requires the SEC to conduct a number of studies and reports. These include a study of the impact of decimalization on the number of public offerings and on the liquidity of the securities of small- and mid-cap companies (decimalization being a factor related to market structure that some commentators assert is responsible for the decline in smaller public offerings); a review of Regulation S-K that involves a comprehensive analysis of its current registration requirements and a determination of how best to update, modernize and simplify these requirements to reduce the costs and burdens for EGCs; and an examination of whether the SEC needs new enforcement tools to prevent circumvention of the rule defining "holders of record." Any of these studies may lead to further Congressional action. We will keep you up to date on these issues as new developments arise.

If you have any questions about this Alert, please contact one of your Cooley team members or one of the attorneys identified above.

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