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The JOBS Act: Removing Significant Regulatory Obstacles to Capital Formation in the United States

The Jumpstart Our Business Startups Act (the JOBS Act) was signed into law by President Obama on April 5, 2012. The JOBS Act seeks to encourage more initial public offerings in the United States and to facilitate other forms of capital formation by reducing some of the burdens imposed on growth-stage companies under U.S. federal securities laws. Several provisions of the JOBS Act became effective immediately while others will not become effective until the U.S. Securities and Exchange Commission (SEC) adopts implementing rules.

We expect the JOBS Act to impact favorably companies seeking to access the U.S. capital markets. Specifically, the JOBS Act: (1) significantly reforms the initial public offering (IPO) process for, and eases regulatory burdens on, a newly defined category of issuers – "emerging growth companies" (referred to as EmGroCs or EGCs), (2) permits general solicitation in certain private offerings targeted at qualified institutional buyers and accredited investors, (3) improves the ability of companies to raise capital in private and small public offerings outside the traditional SEC registration process, and (4) increases the thresholds for the number of shareholders a private company can have before it is forced into the U.S. public reporting regime, allowing more companies to remain "private" longer. While the SEC's rules to implement this statute have yet to be drafted, we expect that foreign companies that qualify as EmGroCs should be able to benefit from this new regime.

This briefing note summarizes key provisions of the JOBS Act and provides an annex with charts that illustrate some of the key concepts.

Under the JOBS Act, emerging growth companies can:

- Escape auditor attestation requirements during a transition period
- Test the waters/pilot fish with QIBs and IAIs
- File IPO registration statements confidentially with the SEC
- Present only two years of financial disclosure in the IPO prospectus
- Have participating underwriters publish research reports

All issuers can advertise and solicit the public for Rule 144A and certain Regulation D offerings so long as purchasers qualify under the rule

IPO On-Ramp

The JOBS Act encourages IPOs by EmGroCs in the United States by eliminating or significantly delaying a variety of regulatory requirements that would otherwise apply. These provisions of the JOBS Act are referred to as the "IPO on-ramp." While other

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provisions of the JOBS Act permit a company to stay private longer, the benefits of the IPO on-ramp provisions weigh in favor of going public before the company's total annual gross revenues reach $1 billion. The IPO on-ramp provisions of the JOBS Act are immediately effective.

Emerging Growth Company. An EmGroC is a new category of issuer that has fewer disclosure obligations in connection with its IPO and during a transition period after the IPO. To qualify, an issuer must have had less than $1 billion in total annual gross revenues in its last fiscal year. A company will no longer qualify for the transitional relief available to EmGroCs upon the *earliest* of:

- the end of the fiscal year in which the company has total annual gross revenues of $1 billion;[1]
- the date on which the company issues more than $1 billion in non-convertible debt in a three-year period;
- the date on which the company becomes a "large accelerated filer"[2]; and
- the end of the fiscal year following the fifth anniversary of its IPO.

EmGroC status is not available for companies whose first public sale of common stock through the SEC's registration process occurred on or before December 8, 2011. Public reporting companies that have never done an IPO, however, may also qualify as EmGroCs. If a company is subject to public reporting requirements only because it has a large shareholder base, it could remain an EmGroC indefinitely to the extent it does not sell common stock through the SEC's registration process and otherwise qualifies.

The longest a company can remain an EmGroC after its IPO is through the end of the fiscal year following the fifth anniversary of its IPO. IPO issuers will want to take this into account when considering the timing of their IPO. To maximize the duration of their EmGroC status, companies will want to consider completing their IPO at the beginning of their fiscal year rather than toward the end of their fiscal year – market conditions permitting.

Confidential submission of IPO filings. An EmGroC may submit its IPO registration statement and subsequent amendments for review and comment on a confidential basis. An EmGroC's initial registration statement and subsequent amendments submitted to the SEC on a confidential basis must, however, all be filed publicly at least 21 days before a road show presentation. This provision is effective immediately and should apply to both domestic and foreign issuers. The SEC will need to set up a process for filing confidentially.

The confidential submission provisions of the JOBS Act have received some public criticism. Commentators have pointed to Groupon as an example of an IPO where investors learned valuable information about the issuer's accounting practices during the early months of Groupon's registration process as a result of SEC and public scrutiny. We expect that savvy institutional investors may well ask an EmGroC during its road show whether the SEC raised any material accounting or disclosure issues during the initial review process. Issuers and their counsel will have to prepare for such questions and consider an issuer's obligation not to engage in selective disclosure of material information.

Only 2 years of audited financials, selected financial data and MD&A required. EmGroCs are only required to include audited financial statements for the prior two fiscal years in their IPO registration statements. Issuers that are not EmGroCs will still be required to provide audited financial statements for the prior three fiscal years. EmGroCs will also need to present only two fiscal years (instead of five fiscal years) of selected financial data and to cover two fiscal years (instead of three fiscal years) in the management's discussion and analysis (MD&A) section of the registration statement. This reduction in required financial information should result in a meaningful cost reduction for EmGroCs.

Testing the waters / Pilot fishing. The JOBS Act permits EmGroCs and their underwriters to communicate orally and in writing with qualified institutional buyers (QIBs) and institutional accredited investors (IAIs) to "test the waters" before and after filing their registration statement. This allows an EmGroC to receive feedback from potential key investors as to how the market may

respond to their offering. This practice is also known as pilot fishing, which is common in Europe but has previously not been possible in the United States. This provision applies to IPOs and follow-on-equity offerings by EmGroCs and is effective immediately. We believe it may soon become market practice for underwriters of public offerings by EmGroCs to schedule pre-road show meetings with key U.S. institutional investors. EmGroCs will need to ensure that the potential investors at test the waters / pilot fishing meetings are all QIBs or IAIs and that the information included in any written materials developed for these meetings is consistent with information presented in their registration statements. Underwriters of public offerings by EmGroCs will need to consider including issuer representations and warranties related to these types of meetings and any related written materials in their underwriting agreements.

Increased availability of research. The JOBS Act provides a new safe harbor from the definition an "offer" in the U.S. Securities Act of 1933 (Securities Act) for research reports relating to EmGroCs. The practical effect of this new safe harbor is to make it somewhat less risky for investment banks to publish these types of research reports because they could not be held liable for any inaccuracies in the reports under the Securities Act. Misleading research reports would, however, still be subject to liability under the SEC's anti-fraud rule under the U.S. Securities Exchange Act of 1934 (Rule 10b-5). Accordingly, investment banks will have continue to be mindful of the U.S. litigation environment when considering whether to take advantage of the relaxed regulation of IPO-related research.

In addition, the JOBS Act prohibits the SEC and any national securities association – such as the Financial Industry Regulatory Authority (FINRA) – from adopting or maintaining any rules that would restrict any broker or dealer from publishing or distributing any research report or making a public appearance with respect to the securities of an EmGroC for any prescribed time periods *after* the initial public offering date. As a result, research reports on EmGroC may be published during the traditional post-IPO "quiet period". Currently, the FINRA Manual includes a rule that generally prohibits, among other things, a manager or co-manager of a securities offering from publishing or distributing a research report or making a public appearance concerning an issuer:

- 40 days following the date of an initial public offering; and
- 15 days prior to and after the expiration, waiver or termination of a lock-up agreement.

After FINRA amends this rule regarding research reports, EmGroCs and their underwriters will want to consider whether to eliminate the automatic extension provisions that have become customary in the "clear market" covenant of equity underwriting agreements and in shareholder lock-up letters.

The JOBS Act also prohibits the SEC and any national securities association (i.e. FINRA) from adopting or maintaining any rules that would restrict an investment banker working on an EmGroC's IPO from arranging meetings and other communications between a securities analyst and the company's management or potential investors and even attend these types of meetings. The JOBS Act's mandated changes to SEC and FINRA rules will not, however, eliminate all restrictions regarding research analysts with respect to EmGroCs. For example, securities analysts would still be subject to the SEC's anti-fraud rules and the unaffected provisions of FINRA's research rules, including a prohibition on participating in efforts to solicit investment banking business. In addition, research analysts will still be required under Regulation AC to certify that the views they express in their research reports accurately reflect their personal views. Furthermore, the restrictions of the SEC's Global Research Analyst Settlement, which banned the practice of analysts accompanying investment banking personnel on pitches and road shows, may continue to apply to the firms that are a party to the settlement. The SEC may issue guidance reminding investment banks of the research rules not implicated by the JOBS Act.

Easing Obligations for EmGroCs During a Transition Period

Once an EmGroC has completed its IPO, it will remain subject to relaxed public reporting requirements during a transition period as long as it continues to qualify as an EmGroC. Depending on the issuer's business and offering activities, the transition period could last for less than a year or up to nearly six years (if the EmGroC's IPO was close to the beginning of its fiscal year).

Auditor attestations and rotation requirements not applicable to EmGroCs. Pursuant to Section 404(b) of the Sarbanes-Oxley Act, public companies are required to annually obtain an auditor attestation report on their internal controls assessments. The JOBS Act eliminates this requirement for EmGroCs during the transition period. In addition, an EmGroC will not be required to comply with any future Public Company Accounting Oversight Board (PCAOB) rules requiring audit firm rotation or auditor supplements during the transition period. Although EmGroCs will be required to include CEO and CFO attestations in their financial reports, the elimination of the Section 404(b) auditor attestation likely represents a meaningful reduction in the cost of being a public company.

This provision may open the door for more registrations by foreign issuers, many of whom view the auditor attestation requirement in the Sarbanes-Oxley Act as among the most significant hurdles to selling securities into the US public market.

Accounting Standards. An EmGroC is not required to comply with any new or revised financial accounting standards adopted by the PCAOB, unless such standards are widely applicable to private companies.

Executive compensation. EmGroCs will only need to disclose the same level of executive compensation as smaller reporting companies. Key examples of the different rules that apply to EmGroCs include the following[3]:

- EmGroCs need only disclose compensation for three (rather than five) named executive officers;
- "Pay versus performance" disclosures addressing the relationship between paid compensation and the financial performance of the issuer will not be required for EmGroCs; and
- EmGroCs need not seek non-binding say-on-pay approval from shareholders nor non-binding approval of M&A related golden parachutes.

JOBS Act's Impact on Unregistered Offerings

General solicitation. The JOBS Act requires the SEC to enact rules allowing general solicitation in connection with private placements under Rule 506 of Regulation D and private placements contemplating resales pursuant to Rule 144A, so long as all purchasers in the Regulation D offering are accredited investors and all purchasers in the Rule 144A resales are QIBs.[4] We expect that an end to the ban on general solicitation will fundamentally change the manner in which domestic Regulation D and Rule 144A offerings are marketed.

The JOBS Act explicitly clarifies that offers and sales made in compliance with revised Rule 506 of Regulation D will "not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation" and will continue to be private placements for purposes of Section 4(2) of the Securities Act. This language should be especially helpful to hedge funds, private equity funds and other issuers conducting Rule 506 offerings that are also seeking to rely on an exemption provided by Section 3(c)(1) or Section 3(c)(7) of the U.S. Investment Company Act of 1940 – as these exemptions are not available to an issuer that engages in a public offering. The JOBS Act's clarification of the intended reach of revised Rule 506 may also be helpful to foreign private issuers, which often conduct Regulation S offerings side-by-side with a private placement in the US that relies on Rule 144A or Regulation D because the prohibition against "directed selling efforts" in Regulation S parallels the traditional "general solicitation" prohibition in Regulation D. We believe the SEC should be encouraged by this statutory clarification to make corresponding changes to the directed selling efforts restrictions of Regulation S when it adopts rules mandated by the JOBS Act permitting general solicitation for Rule 144A and Rule 506 offerings. Without

appropriate clarifications and revisions of Regulation S by the SEC, however, a foreign private issuer conducting a Regulation S offering side-by-side with a Rule 144A or Rule 506 offering could find it difficult to take advantage of the new regime.

We expect the loosening of the general solicitation prohibitions to lead to increased information about private placements becoming available on issuers' websites. For example, companies and funds will be able to post documents relating to their private placements under Rule 144A or Regulation D on their websites without needing to restrict access to QIBs or accredited investors.

Market for 144A offerings may follow the EmGroC rules. JOBS Act provisions that apply to EmGroCs have the potential to change market practice with respect to the financial statements and related disclosure included in offering circulars for Rule 144A offerings. Market practices regarding disclosures for Rule 144A offerings have developed on the basis that the level of disclosure is generally similar to a registered offering. For example, companies that would qualify as EmGroCs may choose to include two years of audited financial statements and related MD&A disclosure instead of three years. This is an attractive proposition for many issuers of securities that are intended to be resold under Rule 144A for the same cost and time savings reasons applicable to EmGroCs that seek to go public. Note that if the securities are proposed to be listed on an exchange that requires three years of audited financial statements, such as the Luxembourg Stock Exchange, the Rule 144A offering materials will still need to include the full three years of audited financial statements.

It is possible that companies that would not otherwise qualify as EmGroCs may also seek to provide two rather than three years of financial information in their Rule 144A offering circulars. This would particularly make sense where the third year is not comparable. We saw a similar trend in the Rule 144A market when the SEC granted first-time IFRS filers flexibility to file only two years of IFRS financials. It is too early to determine how these rules will affect the Rule 144A market for issuers that would not qualify as EmGroCs.

A new exemption covers offerings up to $50 million and allows issuers to test the waters. The JOBS Act requires the SEC to amend Regulation A or adopt a new regulation to increase the maximum amount of securities that an issuer may issue to $50 million (from $5 million) in a 12-month period without registration under the federal securities laws. These securities:

- may be offered and sold publicly;
- are not "restricted securities"; and
- are exempt from state registration if the issuer lists them on a national securities exchange.

Securities that qualify for the exemption are equity, debt, exchangeable or convertible to equity and any guarantees of any of these types of securities.

Such offerings use an abbreviated offering statement form, which is not a registration statement that would trigger the five-year limitation on EmGroC status. After issuance, issuers of these securities must provide audited financial statements to the SEC on an annual basis and may be required to provide more by SEC rulemaking. We note that the current version of Regulation A only applies to U.S. and Canadian issuers. It remains to be seen whether the SEC will adopt rules that would extend the availability of this new private offering exemption to all foreign private issuers.

Crowd funding. Crowd funding is a new, limited exemption from registration under the federal securities laws for fundraising from small investors on the internet. Private companies will be able to raise up to a maximum of $1 million through an SEC-registered broker or a new class of SEC-registered funding portals. Investors in crowd funding are limited to purchasing between $2,000 and $100,000 of securities (depending on their annual income or net assets) and are prohibited from reselling them for one year from the date of purchase, except to the issuer, to an accredited investor, to a family member or through a registered offering. We expect that the SEC rulemaking for the crowd funding exemption will be extensive, and the SEC may need longer than the allotted 270 days to publish final rules.

JOBS Act Gives Companies the Ability to Stay Private Longer

Increased Caps Before Reporting Status Triggered. Prior to the JOBS Act, a company was required to register with the SEC and file periodic reports if it had assets of $10 million or more and a class of equity securities held by 500 or more shareholders of record at the end of its fiscal year. The JOBS Act increases the total shareholder threshold to 2,000, so long as not more than 499 shareholders are non-accredited investors. Certain holders will not be counted as holders under the new caps, including holders of securities issued in exempt transactions pursuant to the new crowd funding regime or under employee compensation plans. We expect that the exclusions from the shareholder of record definition will provide companies with additional flexibility in awarding equity compensation to employees and should lead to an upsurge in private offerings generally.

While these new thresholds will help a private company stay "private" longer, we expect that record keeping in connection with shareholders of record will become more cumbersome as companies now must keep track of which shareholders are not accredited investors. This could become particularly challenging as a result of secondary market trading and when employees sell shares obtained pursuant to compensation plans.

The threshold for terminating public reporting obligations under the SEC's rules, often referred to as "going dark", remains at 300 or fewer shareholders.[5]

Banks and bank holding companies. The new threshold number of shareholders of record for banks and bank holding companies will increase to 2,000 shareholders of record without regard to the number of shareholders of record that are not accredited investors. The threshold for "going dark" for banks and bank holding companies has been changed from 300 or fewer shareholders to 1,200 or fewer shareholders.

Mandated Studies

The JOBS Act mandates several studies that may lead to additional legislation or regulation. For example, the SEC is tasked with conducting a comprehensive analysis of the current disclosure requirements of Regulation S-K, which is the primary regulation governing the information that must be disclosed in registration statements and ongoing SEC reports. The SEC has been tasked with making recommendations on how to streamline the registration process to make it more efficient and less burdensome on EmGroCs. Other mandated studies concern the impact of state securities laws on Regulation A offerings, minimum trading increments for EmGroCs and the enforcement of the anti-evasion provision of Section 12(b)(3).

Conclusion

The JOBS Act sped through Congress, was approved with bipartisan support and promptly signed by President Obama. Its provisions significantly change a number of laws and regulations in a manner that will make it easier for many companies (including foreign private issuers) to go public in the United States, while also facilitating the process for companies to raise capital in the United States privately and stay private longer.

[1] The $1 billion threshold for emerging growth companies could increase every five years to reflect the effects of inflation.

[2] An issuer is a large accelerated filer when the aggregate worldwide market value of its outstanding common equity held by non-affiliates equals or exceeds $700 million (measured each year on the last business day of the issuer's second fiscal quarter) after it has been publicly reporting for at least 12 months and has filed at least one annual report with the SEC.

[3] These particular JOBS Act provisions will not have a practical impact on foreign private issuers, however, because foreign private issuers have historically been exempt from US proxy rules and US disclosure requirements concerning executive compensation under Item 402 of Regulation S-K.

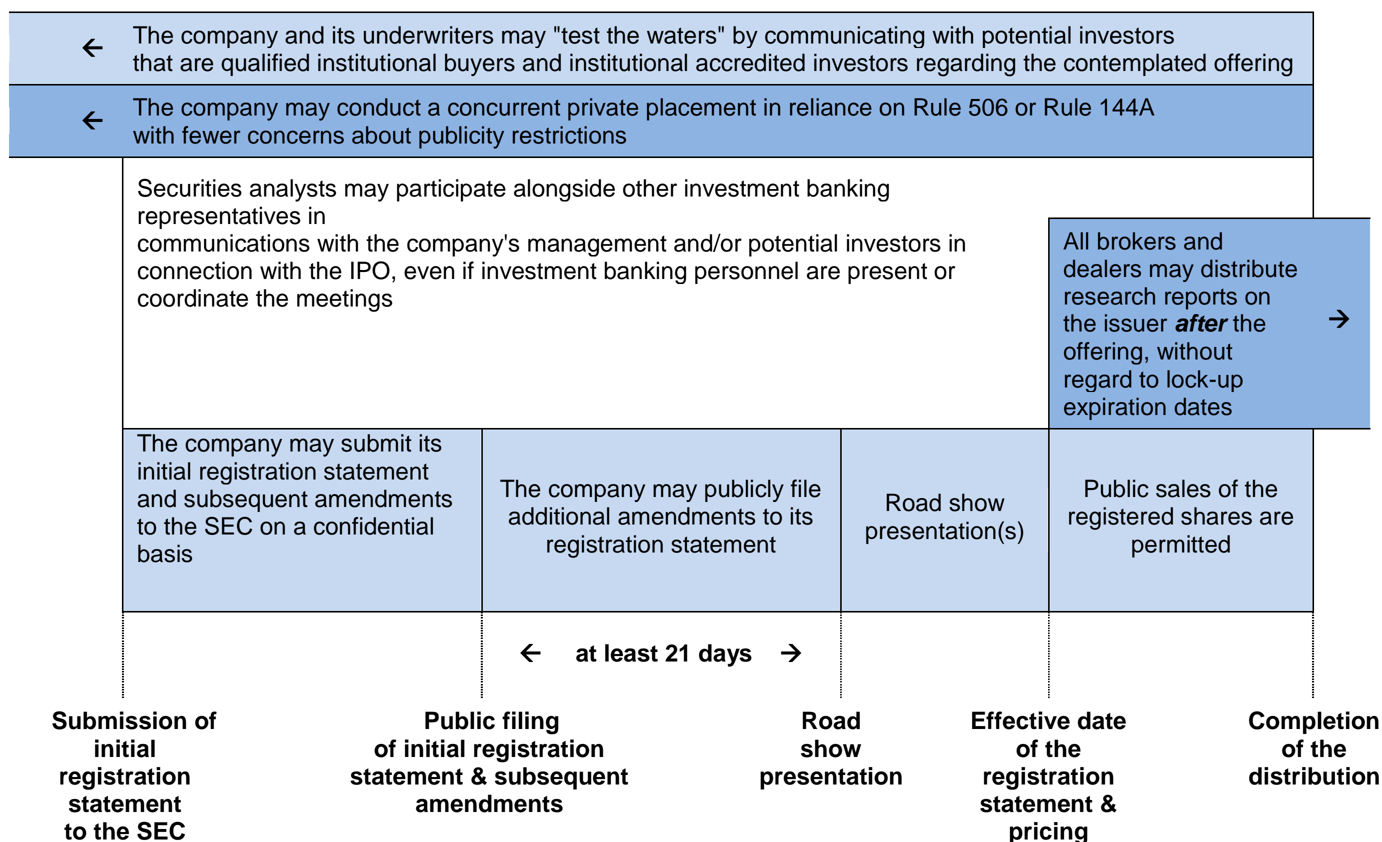
[4] Under Rule 506 of Regulation D, an issuer will still have the option to sell its securities to a maximum of 35 non-accredited investors that are also sophisticated if it complies with the original ban on general solicitation.

[5] The JOBS Act does not amend the provisions Rule 12h-6(a)(4) under the U.S. Exchange Act of 1934, which permits foreign private issuers to deregister when US trading volume is 5% or less of worldwide trading volume

Annex

Key JOBS Act Provisions	To which issuers does it apply?	When does it becomes effective?
Pre- and post-filing communications with QIBS and IAIs to "test the waters"	Only EmGroCs	Effective immediately
Confidential submission of draft IPO registration statements to the SEC	Only EmGroCs	Effective immediately
Delays requirement for auditor attestations on an issuer's internal controls pursuant to Section 404(b) of the Sarbanes-Oxley Act during the transition period	Only EmGroCs	Effective immediately
Only two years of audited financial statements, MD&A and selected financials in IPO registration statement; relaxed public reporting in subsequent SEC filings	Only EmGroCs	Effective immediately
Publication and distribution of research reports by participating underwriters	Only EmGroCs	Statutory amendment effective immediately; additional FINRA rule making required for implementation
General solicitation allowed for Rule 144A and Regulation D (Rule 506) offerings	All issuers	When the SEC adopts implementing rules
New exemption (similar to Regulation A) with $50 million annual offering maximum	All issuers	Statutory amendment effective immediately; additional SEC rule making required for implementation
New exemption for crowd funding	Only applies to non-public U.S. issuers	When the SEC adopts implementing rules
Increased shareholder thresholds under Section 12(g) for public company reporting	All issuers	Statutory amendment effective immediately; additional SEC rule making required for implementation

Initial Public Offering Timeline for an Emerging Growth Company



Comparative Financial Disclosure Requirements		
	Emerging Growth Companies	**All Other Companies**
Years to be covered in MD&A	2 fiscal years	3 fiscal years
Audited financial statements for IPO of common equity	2 fiscal years	3 fiscal years
Selected Financial Data	2 fiscal years	5 fiscal years
Is an auditor attestation report on management's internal control assessment required?	No	Yes
After their IPO, EmGroCs do not need to provide financial disclosure for periods prior to those disclosed in the IPO		

Summary of Amended Shareholder-Based Reporting Triggers		
Criteria	**Banks & Bank Holding Companies**	**All Other Companies**
Total number of shareholders of record • **excludes holders who received their shares pursuant to an employee compensation plan in transactions exempt from SEC registration requirements** • **excludes holders of securities purchased in exempt crowdfunding offerings**	2,000 record holders	2,000 record holders OR 500 non-accredited investors
Total assets at fiscal year-end that would trigger requirements to register the issuer with the SEC within 120-days if the applicable total shareholder number has been reached	$10 million	$10 million
Number of shareholders of record that would permit the issuer to exit registration and ongoing reporting obligations	1,200 record holders or fewer	300 record holders or fewer
When do these provisions become effective?	At the end of the issuer's first fiscal year following the enactment of the JOBS Act	Simultaneously with the enactment of the JOBS Act

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