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Pending JOBS Act to Encourage IPOs in the United States and Reduce Legal Restrictions for Private Companies Raising Capital prior to an IPO

Private companies have long faced a host of regulatory obstacles in their quest for capital in the United States, whether in the private markets or via an IPO in the public markets. Most of these obstacles result from a one-size fits all approach under the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”) and from the fact that regulation of the securities offering process by the Securities and Exchange Commission (the “SEC”) has not kept up with technological advances or changes in syndication practices.

In spite of declines in the number of IPOs in the United States both in absolute terms and relative to other markets, particularly in the number of IPOs by smaller companies, and calls from a number of market participants, trade organizations and others (including the Department of the Treasury) to reduce costs and other barriers to accessing the markets, there had been little movement on the regulatory front to ease access to the US markets. Similarly, in spite of the broad modifications to the communications rules in 2005 and the perceived benefits of greater interaction between IPO candidates and investors outside the formal roadshow process, there had been little progress in lowering the burdens faced by companies (whether large or small) wishing to test the waters before committing themselves to access the US markets. Significant relief now appears to be imminent as a result of Congressional action.

On March 8, the House of Representatives passed the *Jumpstart Our Business Startups Act* (the “JOBS Act”), and on March 22, the Senate approved the House version of the legislation, with a few amendments. The White House has endorsed the JOBS Act, and it is expected that the JOBS Act will become law in the near future after the differences in the two versions have been reconciled. The principal differences relate to the so-called “crowd-funding” provisions (with the Senate version being more restrictive).

The JOBS Act contains two categories of reforms – changes to the IPO process and changes designed to facilitate access by private companies to capital in the United States. The first category of changes will be effective upon enactment of the JOBS Act, and the second category will, in certain cases, be effective upon promulgation of rules by the SEC and, in other cases, will be effective immediately. Changes will benefit both domestic companies and foreign private issuers.

If as expected it is enacted, the JOBS Act will have a significant favorable impact on companies seeking to access capital markets in the United States. Companies with annual gross revenues below $1 billion will be the principal beneficiaries of the JOBS Act reforms, but there are other provisions that will benefit a far broader range of private companies seeking to access capital in the private markets in the United States (including the Rule 144A market).

Changes to the IPO process

Title I of the JOBS Act would amend the Securities Act and the Exchange Act to make the IPO process easier and to lessen post-IPO reporting requirements for emerging growth companies (a new category of issuers, which is described below).

IPO-related accommodations. Emerging growth companies would benefit from a number of accommodations in the IPO process. An emerging growth company would:

- be permitted to provide two years of audited financial statements in its IPO registration statement rather than the three years currently required (and the management's discussion and analysis of financial condition and results of operations section of its registration statement would only need to cover two years, rather than three);
- be exempt from providing selected financial data for any period prior to the earliest audited period presented in its IPO registration statement (currently, selected financial data must be provided for the previous five years);
- have the option of complying with disclosure requirements applicable to smaller reporting companies with respect to executive compensation; and
- be permitted to submit its IPO registration statement and subsequent registration statements for SEC review on a confidential basis, provided a public filing is made at least 21 days prior to the roadshow for the applicable public offering.

The JOBS Act would permit investment banks to publish research related to an emerging growth company notwithstanding a pending IPO or other offering, or the expiration of related lock-up periods. This would be the case even if the investment bank publishing the research is participating in the offering. Research in this context means a written, electronic or oral communication that includes information, opinions or recommendations with respect to securities of an issuer or analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision. Research analysts would also be permitted to participate in meetings with an emerging growth company together with investment banking staff.

Furthermore, an emerging growth company would be permitted to meet, or communicate in writing with, qualified institutional buyers or accredited investors to gauge their interest in the IPO (that is, to test the waters), both prior to and following the filing of its registration statement.

Reporting requirements. Following an IPO, emerging growth companies would be exempt from a variety of requirements to which they would otherwise become subject as public companies. An emerging growth company would not be subject to the auditor attestation report on its internal controls assessment under Section 404(b) of the Sarbanes-Oxley Act. It would not need to hold shareholder advisory votes on executive compensation or golden parachutes. It would not need to provide the full range of executive compensation disclosures required of other domestic reporting companies, as it would have the option of complying with standards applicable to smaller reporting companies with respect to executive compensation, and would not need to calculate and disclose pay versus performance ratios and the ratio of compensation of the CEO to the median compensation of all employees. An emerging growth company also would not need to present selected financial data for any period prior to the earliest audited period presented in its IPO registration statement and would not be required to comply with any new or revised financial accounting standard until private companies are also required to comply with that standard.

Emerging growth companies. An "emerging growth company" would be a company that had total annual gross revenues of less than $1 billion during its most recent fiscal year. This threshold would be indexed for inflation every five years. An emerging growth company would retain its status as such until the earliest of:

- the first fiscal year after its annual revenue exceeds $1 billion;
- the first fiscal year following the fifth anniversary of its IPO;
- the date when the company has issued more than $1 billion in non-convertible debt securities over the previous three-year period; and
- the first fiscal year in which the company becomes a large accelerated filer (meaning reporting for at least one year with $700 million of public equity float).

A company that had sold, under an effective registration statement, common equity securities on or before December 8, 2011 cannot qualify as an emerging growth company.

Impact. For companies qualifying as emerging growth companies that wish to go public, the JOBS Act is expected to reduce audit costs and other IPO-related costs, as well as public reporting costs. In addition to the reduced financial burden, the process should be more rational. The JOBS Act would permit emerging growth companies to explore the IPO option without disclosing to the market the fact that it is seeking to go public or disclosing the information contained in its Form S-1 or F-1 until the company is ready to conduct its roadshow. Changes to the rules governing research and pre-IPO communications will greatly facilitate testing investor sentiment prior to launch.

The requirement for an auditor attestation report on internal controls imposes a significant financial burden on companies and has been cited as one of the reasons why fewer private companies go public in the United States. The exemption from this requirement would reduce costs in the early years. A reduction in the level of executive compensation disclosure should also reduce compliance costs and management and board resources allocated to collecting compensation information for proxy solicitation materials.

Private Capital Reforms

General solicitation/general advertising. The JOBS Act directs the SEC to modify Rule 506 of Regulation D under the Securities Act and Rule 144A under the Securities Act to eliminate the prohibition on "general solicitation and general advertising" as it applies to offers and sales of securities made pursuant to those Rules. The prohibition against general solicitation and general advertising would not apply to offers of securities made pursuant to Rule 506 so long as all purchasers are accredited investors. (Reasonable steps would need to be taken to verify the purchasers' status as accredited investors, using methods to be promulgated by the SEC.) The prohibition against general solicitation and general advertising would not apply to offers of securities made pursuant to Rule 144A, provided that securities are sold only to persons reasonably believed to be qualified institutional buyers.

The JOBS Act would also create an exemption from broker-dealer registration for certain persons in connection with the issuance of securities in compliance with Rule 506. Persons who facilitate offers, sales, purchases or negotiations with respect to securities issued in compliance with Rule 506, persons who permit general solicitations or general advertisements by issuers of such securities, persons who co-invest in such securities or persons who provide ancillary services with respect to such securities would not be required to register as broker-dealers. However, no compensation could be paid, and such persons could not be in possession of customer funds or securities, in connection with the purchase and sale of the securities.

Threshold for registration. The JOBS Act would also raise the threshold that triggers Exchange Act registration (under Section 12(g)) based on the number of shareholders. In place of the threshold of 500 holders of record, companies would be required to register only when they have more than $10 million in assets and a class of their equity securities is held of record either by 2,000 persons or by 500 persons who are not accredited investors. For banks and bank holding companies, the threshold would be 2,000 persons. In addition, the definition of "held of record" would be modified to exclude securities held by persons who received them pursuant to an employee compensation plan in transactions that were exempt from registration. Purchasers of securities under the "crowd-funding" provisions (see below) would also not count towards the securities deemed "held of record."

For bank and bank holding companies, the threshold that permits deregistration (under both Section 12(g) and Section 15(d) of the Exchange Act) would also change from 300 persons to 1,200 persons.

Crowd-funding. The House version of the JOBS Act would create a new registration exemption for private companies selling securities, provided that not more than $1 million of securities are sold in a 12-month period (or if certain financial information is provided, the threshold is increased to $2 million of securities), and the amount sold during that period to any one investor does not exceed the lesser of $10,000 or 10% of the investor's annual income. There would be nominal disclosure and other requirements applicable to the offering process, but intermediaries would not be required to register as broker-dealers. The Senate version has more restrictive provisions (including lower thresholds and a requirement that intermediaries be registered broker-dealers), and these will need to be reconciled with the House version. The term crowd-funding refers to accessing small amounts of capital via online platforms.

Regulation A. The threshold for offerings under Regulation A (small offerings) would be increased from $5 million in a 12-month period to $50 million during that period.

Aligning the general solicitation and general advertising provisions, particularly in the context of Rule 144A offerings, with the realities of the internet age and the global marketplace makes sense, as does addressing the 500-shareholder limitation. News of private placements often appear in the trade press ahead of launch, and foreign issuers accessing the U.S. markets via Rule 144A often have to walk a fine line as to what is and is not permissible publicity to ensure they can avail themselves of a registration exemption, and counsel often has to draw artificial distinctions in order to render "no registration" opinions. As the "directed selling efforts" requirement of Regulation S remains in place, consideration will still need to be given to publicity restrictions. In addition, the "general solicitation and general advertising" concept is a key factor in determining who placement agents and initial purchasers can approach and when. The benefits of these changes will depend in large part on the details of the SEC's mandated rulemaking. As to the other reforms, it remains to be seen whether relaxation of the basic private placement regime as contemplated by the crowd-funding amendments, even on a limited basis, will continue to ensure adequate levels of investor protection that have been the central feature of the private placement regime for years.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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