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CONGRESS ACTS TO ENCOURAGE IPOS IN THE U.S. AND REDUCE LEGAL RESTRICTIONS FOR PRIVATE COMPANIES RAISING CAPITAL PRIOR TO AN IPO

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MARCH 29, 2012

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 IPO Task Force that presented a report to the Department of the Treasury last October) to reduce costs and other barriers to accessing the markets, there had been little movement on the regulatory front to ease access to the U.S. 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 U.S. markets.

Significant relief is imminent as a result of Congressional action. On March 27, Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act"). The White House has previously endorsed the JOBS Act, and it is expected that the JOBS Act will become law shortly.

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, with certain exceptions, foreign private issuers.

While it can be debated whether this legislation will have, as its acronym implies, an impact on employment in the United States, it 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 amends 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 will benefit from a number of accommodations in the IPO process. An emerging growth company:

- will 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 will only need to cover two years, rather than three);
- will 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);
- will have the option of complying with disclosure requirements applicable to smaller reporting companies with respect to executive compensation; and
- will 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 will 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 will 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 will also be permitted to participate in meetings with an emerging growth company together with investment banking staff.

Furthermore, an emerging growth company will be permitted to meet, or communicate in writing with, qualified institutional buyers or institutional 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 will be exempt from a variety of requirements to which they would otherwise become subject as public companies. An emerging growth company will not be subject to the auditor attestation report on its internal controls assessment under Section 404(b) of the Sarbanes-Oxley Act. It will not need to hold shareholder advisory votes on executive compensation or golden parachutes. It will not need to provide the full range of executive compensation disclosures required of other domestic reporting companies, as it will have the option of complying with standards applicable to smaller reporting companies with respect to executive compensation, and will 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 will not need to present selected financial data for any period prior to the earliest audited period presented in its IPO registration statement and will 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" will be a company that had total annual gross revenues of less than $1 billion during its most recent fiscal year. This threshold will be indexed for inflation every five years. An emerging growth company will 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 will 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 will 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 will not apply to offers of securities made pursuant to Rule 506 so long as all purchasers are accredited investors. (Reasonable steps will 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 will 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 will 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 will 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 will 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 will 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 will be 2,000 persons. In addition, the definition of "held of record" will 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 so-called "crowdfunding" provisions (see below) will 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) will also change from 300 persons to 1,200 persons.

Crowdfunding. The term "crowdfunding" refers to accessing small amounts of capital, principally via online platforms. The JOBS Act will create a new registration exemption for private companies selling securities. The exemption will be available provided, among other things, that not more than $1 million of securities are sold in a 12-month period and the aggregate amount sold to any one investor during that period is capped at a specified level based on the annual income or net worth of the investor. If an investor's annual income or net worth is less than $100,000, then the aggregate amount sold to the investor cannot exceed the lesser of $2,000 or 5% of the investor's net worth or annual income. If an investor's annual income or net worth is $100,000 or more, then the aggregate amount sold to the investor cannot exceed the lesser of $100,000 or 10% of the investor's net worth or annual income. (These amounts will be indexed for inflation every five years.)

The crowdfunding exemption will have other conditions as well, some that apply to intermediaries and some that apply to issuers. Among other conditions, intermediaries will have to be registered with the SEC as brokers or as "funding portals," the latter being a new type of intermediary that performs limited functions. Intermediaries will be tasked with a variety of duties and obligations. For example, intermediaries will be required to provide investors with certain information (such as disclosures related to risks and other investor education materials); ensure that investors review the disclosures provided, affirm their understanding of the risks and answer questions demonstrating an understanding of the risks; take measures to reduce the risk of fraud, including conducting background checks on officers, directors and holders of more than 20% of the shares of issuers; make available to the SEC and potential investors the disclosure required to be provided by issuers; undertake such efforts as the SEC determines appropriate to ensure that no investor has exceeded its cap on the aggregate amount of securities purchased and provide proceeds to the issuer only when the target offering amount is reached or exceeded.

Issuers will be required to provide a limited amount of information to the SEC, investors and the relevant brokers or funding portals. Issuers will be unable to advertise the terms of the offering except through notices that direct investors to the broker or funding portal. Compensation of intermediaries will be subject to rules designed to ensure that recipients disclose receipt of compensation. Issuers will also be subject to requirements to provide information at least annually covering their results of operations and financial statements, as may be determined by the SEC.

The JOBS Act also addresses liability for misstatements and omissions in crowfunding offerings and imposes a one-year lock-up on the securities sold, subject to certain limited exceptions.

The crowdfunding exemption will not be available to foreign companies (note the term "foreign private issuer" is not used), SEC reporting companies, investment companies and companies excluded from the definition of investment company by virtue of section 3(b) or 3(c) of the Investment Company Act of 1940.

The SEC is directed to promulgate disqualification provisions and will need to promulgate other rules to address various aspects of the crowfunding exemption. Securities acquired pursuant to the crowdfunding exemption will be exempt from registration or qualification under state blue sky laws.

Regulation A. The threshold for offerings under Regulation A (small offerings) will be increased from $5 million in a 12-month period to $50 million during that period. Issuers using Regulation A to offer securities will be required to file annually audited financial statements with the SEC. The SEC, through its rulemaking, may also choose to require issuers to provide periodic disclosures about the issuer, its business operations, its financial condition and other matters.

Impact. 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. 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 crowdfunding amendments will continue to ensure adequate levels of investor protection. The SEC will have a lengthy list of issues to address.

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