McDermott Will & Emery

Newly Enacted JOBS Legislation Should Encourage Initial Public Offerings

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While the recently enacted JOBS Act contains numerous provisions that may or may not result in the creation of actual jobs, enterprises that fall under the definition of "emerging growth companies" (EGCs) will see great potential benefits from provisions that may streamline the IPO process, pave the way to public ownership and improve access to capital.

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups (JOBS) Act (the Act). The acronym may be a misnomer because the likely impact of the legislation on job creation is debatable. But the word “jumpstart” in the title seems appropriate, at least with respect to the provisions that are intended to facilitate and encourage initial public offerings (IPOs). The Act scales back a number of provisions of the Sarbanes-Oxley Act of 2002 (SOX), the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), and other federal securities laws and regulations as they apply to “emerging growth companies” (EGCs), which includes all companies conducting an IPO other than those with $1 billion or more in revenues in their most recently completed fiscal year. Congress intended the Act to provide a so-called “on-ramp” for IPO issuers in order to make the IPO process less burdensome, ease their transition to public ownership and improve their access to capital.

It has been widely reported that members of the U.S. Congress from both sides of the aisle were frustrated with what they saw as the failure of the Securities and Exchange Commission (SEC) to relax its rules to alleviate the impact of certain regulations on new and smaller issuers, particularly in light of the economic downturn and the weak IPO market. As a consequence, the Act is unusual in its implementation method. With few exceptions, the EGC provisions are self-executing and effective immediately; they are not to be accomplished through mandated SEC rulemaking but, rather, are direct amendments to the applicable securities laws that have the effect of denying the SEC the power to make contrary rules. It is not surprising, then, that the SEC and individual commissioners have been highly critical of the Act in public appearances and written communications to Congress.

While the Act has been criticized broadly and described by one critic as “painting a path to fraud on Wall Street,” it enjoyed broad bipartisan support. The original House of Representatives version passed by a margin of 390 to 23. After making certain amendments, the Senate passed the Act by a vote of 73 to 26; when returned to the House in amended form it was approved 380 to 41. Throughout the process, President Obama supported it and indicated an intention to sign it.

This white paper focuses on the provisions of the Act that apply to EGCs and their public offerings. The Act also contains other provisions not within the scope of this document, including so-called “crowdfunding” (the subject of the Senate amendments designed to allay concerns about potential fraud) and provisions applicable only to private companies and offerings.

The Act includes two general types of provisions related to EGCs: those intended to facilitate the IPO process itself and those intended to make the initial years of life as a public company more attractive and less burdensome.

EMERGING GROWTH COMPANY – SECTION 101

An “emerging growth company” is any company that had total gross revenues of less than $1 billion during its most recently completed fiscal year. That amount is to be adjusted for inflation every five years. An issuer's EGC status ends upon the earliest of 1) the last day of the fiscal year in which it had total gross revenues over $1 billion, also as adjusted for inflation, 2) the last day of the fiscal year following the fifth anniversary of its IPO, 3) the date on which it has issued more than $1 billion (not inflation adjusted) in non-convertible debt in the previous three-year period, or 4) the date on which the issuer is deemed a “large accelerated filer,” which generally means that it has $700 million or more of aggregate worldwide market value. For IPOs completed early in an issuer’s fiscal year, the fifth-year anniversary provision could mean a reprieve of nearly six years.

The testing of EGC status is to be made at the end of the issuer’s fiscal year, except with respect to the issuance of $1 billion of non-convertible debt in a three-year period, in which case termination would be immediate. Both domestic and foreign issuers may qualify as an EGC.

The Act’s EGC provision is directly targeted at new registrants and intends to encourage IPOs. It does not relax any regulations for other public companies, no matter how small or new to the public markets. Companies that first sold common equity securities pursuant to a Securities Act of 1933 (1933 Act) registration statement, on or before December 8, 2011, the date the Act was first

introduced in the House, do not qualify as EGCs, but those currently in registration or that completed an IPO on or after December 8 can still qualify.

IPO PROCESS PROVISIONS

Financial Information – Section 102(b). In connection with its IPO, an EGC must now provide only two years of audited financial statements, rather than the traditional three years, and need not provide selected financial data for periods prior to the earliest audited period presented. Previously, five years of selected financial data were required. In connection with other registration statements and periodic and other reports under the 1933 Act and the Securities Exchange Act of 1934 (the 1934 Act), an EGC need not provide selected financial data for periods prior to the earliest audited period presented in connection with its IPO. This is another somewhat striking provision, because the requirement for three years of audited financial statements and five years of selected financial data far predate Dodd-Frank and SOX.

The provision requiring just two years of financial statements specifically applies only to the EGC's IPO registration statement, while the provision concerning selected financial data also applies to any other SEC filing. Read literally, these provisions would suggest that an EGC that, for example, completes its IPO in May of 2012 would only need to present audited financial statements and selected financial data for 2010 and 2011; however, in a later registered offering, say in December of 2012, the EGC would need to provide audited financial statements for 2009 as well. Even more anomalous, the provisions imply that no selected financial data for periods earlier than 2010 would be required in connection with that later offering.

Research and Analysts – Section 105(a) and (b). The Act makes it easier for investment banks to assist in preparing and marketing the offerings of EGCs. The Act prohibits the SEC and national securities exchanges registered under the 1934 Act from adopting or maintaining any rule or regulation prohibiting any broker, dealer or exchange member from publishing or distributing any research report or making a public appearance with respect to an EGC during any prescribed period after the EGC's IPO or prior to the expiration of an underwriters' lockup agreement. The elimination of these so called "quiet-period" restrictions *after an offering* is a very substantial change.

Even more significantly, the Act amends Section 2(a)(3) of the 1933 Act to provide that, in connection with any public offering of common stock by an EGC, not just its IPO, a research report — even one by a broker-dealer participating in the offering — about an EGC that has filed *or intends to file* a 1933 Act registration statement does not constitute an offer of the security. The use of research reports before completion of an IPO has always been prohibited, initially by the requirement that the only permissible offering document was a statutory prospectus and later by National Association of Securities Dealers (NASD) or Financial Industry Regulatory Authority (FINRA) rules. However, a literal reading of this provision of the Act would appear to allow, for the first time ever, the publication of investment banker research reports even before the consummation of an offering, including an IPO, and even if directly used in marketing the offering.

The use of research reports as part of an IPO marketing process would be a radical change. However, even if the Act is read to allow this, it seems unlikely that it would become common practice. Certain liability provisions of the securities laws would still apply to those underwriter-created documents and it doubtful that underwriters would choose to expose themselves to that risk. If research reports are used to market offerings, underwriting agreements will need to be revised substantially to deal with liability, indemnification, issuer review and approval rights, and other issues that such early research reports would raise.

The Act also prohibits the SEC and any national securities association from adopting or maintaining any rule that would, in connection with the IPO of an EGC 1) restrict, based on functional role, the broker-dealer personnel who may arrange meetings between analysts and accredited investors, or 2) restrict a securities analyst from participating in communications with management of an EGC so long as non-analyst broker-dealer personnel are also participating. Investment bankers can now directly arrange for analysts to meet with accredited investors about EGC IPOs and analysts can participate in meetings with management to prepare the offering documents and presentations to be used in connection with the offering.

These provisions that free analysts from certain restrictions with respect to EGCs also have been criticized broadly. However, it is important to note that there are still many other substantial restrictions in place designed to ensure the integrity of research reports. These include Regulation AC, adopted pursuant to SOX, which requires broker-dealers to include in a research report a certification by the research analyst that the report accurately reflects the analyst's personal views and to disclose whether or not the analyst received any compensation or other payments in connection with his or her specific recommendations or views. They also include stock exchange rules that, among other things, prohibit pre-publication review of research reports by investment

banking personnel, solicitation of investment banking business by analysts, and influence by investment banking personnel on analyst compensation or retaliation against an analyst as a result of an unfavorable research report.

Finally, pursuant to the 2003 Global Research Analyst Settlement among the SEC and 12 investment banks, the banks agreed, among other things, to court-ordered restrictions on joint communications with clients by investment banking personnel and analysts. Such communications must be chaperoned by compliance or legal personnel and may only be for the purpose of due diligence. Unless the court grants relief from these restrictions, the investment banks party to this settlement will not be able to take full advantage of the Act's relief.

Test the Waters – Section 105(c). Section 5 of the 1933 Act has been revised to allow EGCs and anyone acting on their behalf (including underwriters) to have oral or written communications with institutional "accredited investors" and "qualified institutional buyers" (defined terms under the 1933 Act) before or after filing a registration statement. The provision describes the purpose of these communications as "to determine whether such investors might have an interest in a contemplated offering." Whether this phrase is intended to place any real limitation on the substance of these communications is unclear. It seems that it would be difficult to distinguish between "determining interest" and sales efforts. If, however, these communications are deemed to constitute road shows, the interplay of this provision and the confidential submissions provision is uncertain.

Confidential Submissions – Section 106(a). EGCs may now, in connection with an IPO but not any subsequent offering, submit draft registration statements, amendments and other documents to the SEC on a confidential basis for review. In order to ensure eventual full transparency, however, the Act requires that the confidential registration statement and all amendments must be filed publicly with the SEC not later than 21 days before the date on which the EGC first conducts a "road show" (which is broadly defined). These confidential submissions also will not be subject to disclosure under the Freedom of Information Act.

This provision should certainly make it more attractive for a company to pursue an IPO. In the event of a delayed or unsuccessful offering, the otherwise confidential information contained in its registration statement will not be available to its competitors, customers, suppliers, employees and other parties. This "fish bowl" concern has always been a meaningful disincentive to pursuing an IPO because of the high percentage of filings that do not result in a successful sale.

There is a possible tension between this provision and the "test the waters" provision described above. If the now-permissible pre-filing communications between the EGC and its representatives and certain investors are deemed road shows, then the occurrence of such meetings would seem to preclude a subsequent confidential submission. Although that is a literal reading of the Act, it appears unlikely that Congress intended that EGCs be required to choose between submitting a draft registration statement confidentially and testing the waters.

As with most of the Act, the SEC was not supportive of confidential submissions. It should also be noted that, for EGCs, this provision effectively reverses the SEC's recently imposed limits on the ability of foreign private issuers to submit draft filings on a confidential basis (see our December 2011 *On The Subject* regarding this topic).

Although the Act did not specify the manner in which confidential submissions should be made, or require the SEC's Division of Corporation Finance to establish a process within a specified timeframe, the SEC acted quickly and on April 5, 2012, released guidance on the topic. Until the SEC fully implements a system for electronic submissions, registrants may submit draft registration statements in a text-searchable PDF file on a CD/DVD or, alternatively, in unstapled and unbound paper form.

In an April 2, 2012, article, *The Wall Street Journal* addressed accounting disagreements between the registrants and the SEC and suggests that confidential submissions could be used to prevent investors from finding out about accounting and other issues because they would allow a company "to resolve such issues under the radar." This concern seems unfounded given the application of other SEC disclosure rules and the specifics of the confidential submissions provision.

Correspondence with the SEC has been and remains confidential until well after the consummation of an IPO. Investors become aware of issues that companies are having with the SEC during the IPO review process, either because the company discloses them or because investors and analysts review the various versions of the registration statement and look for clues provided by the changes from one iteration to the next.

Because all of the versions of the registration statement must be filed publicly three weeks before the first road show (which is still generally two or more weeks before consummation of the IPO), it would seem that investors and analysts would still have

ample time to try to ferret out the clues regarding the SEC's concerns the same way they always have. Moreover, all IPOs must still obtain SEC clearance before a registration statement becomes effective. If the SEC believes that investors should be provided more detail about a disagreement between an EGC and the SEC that was resolved during the review process, the SEC should be free to require that disclosure as a condition of effectiveness.

PROVISIONS TO EASE TRANSITION TO PUBLIC OWNERSHIP

Stockholder Votes on Pay – Section 102(a). The Act amends Section 14A of the 1934 Act to provide that EGCs need not comply with the requirements to provide stockholders with a "say-on-pay," "say-on-frequency" or "say-on-golden parachutes." Those latter provisions were mandated by Dodd-Frank and adopted by the SEC in February of 2011. This provision and those regarding the disclosure of executive compensation are interesting because the rules they nullify for EGCs were enacted very recently. Unless Congress found fault with the specific rules adopted by the SEC in those areas, this represents a rather abrupt turnaround in position. In passing Dodd-Frank, Congress could have simply provided that the new vote-on-pay and executive compensation disclosure rules that were mandated by Dodd-Frank not apply to EGCs.

When an issuer ceases to be an EGC, it will still be afforded an exemption from the "say-on-pay" provision that will last until the later of three years after its IPO or one year after it ceases to be an EGC.

Disclosure of Executive Compensation – Section 102(a) and (c). EGCs are exempted from the provisions of Section 953 of Dodd-Frank which require additional disclosure about certain compensation matters, including pay-for-performance and the ratio between the CEO's total compensation and the median total compensation of all other company employees. These provisions, particularly the CEO compensation ratio, have been criticized as overly complex and burdensome and unlikely to provide information that is important enough to justify the cost and effort. EGCs will also be exempt from the detailed Compensation Discussion and Analysis disclosure requirements and will be allowed to report scaled executive compensation under the rules that apply to smaller reporting companies.

Accounting Standards – Section 104. The Act even grants relief from requirements that are not yet in place. The Act provides that EGCs will not be required to comply with any new or revised financial accounting standard until the date on which companies that are not "issuers" under SOX must so comply. This means that any new accounting standards that apply only to SEC-registered companies will not apply to EGCs and that any phase-in of accounting standards provided for private companies will also be available to EGCs.

Internal Controls Audit – Section 103. Probably the most anticipated provision, and one quite likely to significantly reduce issuer compliance costs, is the amendment of Section 404(b) of SOX to eliminate, for EGCs, the requirement to obtain an internal controls attestation from their auditors. Since the adoption of SOX, the expense associated with this requirement has made it one of the most criticized provisions of SOX and it is not surprising that scaling it back was a key objective of Congress.

Other Auditing Provisions – Section 104. The Act exempts EGCs from provisions of any future Public Company Accounting Oversight Board (PCAOB) regulations that might require mandatory auditor rotation or a supplement to the auditor's report in which the auditor would be required to provide a so-called "Auditor Discussion and Analysis" akin to "Management's Discussion and Analysis" and "Compensation Discussion and Analysis." Proposed rules on these topics have not even been formally proposed by the PCAOB, but they have been under consideration for some time and are the subject of PCAOB concept releases.

In addition, any future rules adopted by the PCAOB will not apply to an EGC unless the SEC determines the application 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."

SEC DIRECTIVES – SECTION 106(B) AND 108

As noted, most of the Act's EGC provisions are implemented directly and not by directives to the SEC to implement rules. There are, however, two areas where the SEC is directed to undertake actions.

First, the Act directs the SEC to conduct a study as to the impact that trading and quoting securities in one-penny increments (also known as "decimalization") has had on the number of IPOs since the implementation of decimalization in 2001 and with regard to the impact of decimalization on market liquidity for small- and mid-cap company securities. The SEC is directed to complete this study within 90 days, and if it determines that a minimum increment greater than one penny should be used for EGCs, it is

authorized to issue rules to designate a higher minimum increment, but no greater than $0.10, no later than 180 days after enactment of the Act.

Second, the Act directs the SEC to comprehensively analyze Regulation S-K to determine how its requirements, as applied to EGCs, can be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with those requirements. A report of this analysis is to be submitted to Congress no later than 180 days after enactment of the Act.

OPT IN – SECTION 107

An EGC can chose to forego the benefit of any exemption provided by the Act and, instead, comply with the requirements applicable to non-EGCs. However, with respect to the relief relating to new or revised financial accounting standards, an EGC must make an all-or-nothing compliance choice when it is first required to file a registration statement or report under the 1934 Act and notify the SEC of that choice. It may not pick and choose among standards with which to comply.

For more information regarding the JOBS Act and how it applies to EGCs and their public offerings, please contact your regular McDermott lawyer, or:

Thomas J. Murphy: +1 312 984 2069 tmurphy@mwe.com

Jonathan P. Rochwarger: +1 212 547 5558 jrochwarger@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com

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