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IPO On-Ramp: Analysis and Open Issues

As the impact of the JOBS Act begins to sink in, several issues have begun to emerge relating to Title I - Reopening American Capital Markets to Emerging Growth Companies, commonly referred to as the "IPO On-Ramp." Title I is designed to streamline the IPO process and simplify, for up to five years, the Securities Exchange Act reporting requirements for so-called "Emerging Growth Companies." In this alert, we detail some of the rising issues associated with the IPO On-Ramp and how issuers and investment bankers may approach these issues in the future. **Emerging Growth Companies** Title I is applicable only to the newly-created class of issuers called emerging growth companies. An emerging growth company ("EGC") is a company which has total gross revenues of less than $1 billion for the last completed fiscal year and would not qualify as a "large accelerated filer," as defined by Securities and Exchange Commission ("SEC") rules. Furthermore, an EGC cannot have sold common equity securities pursuant to an effective registration statement before December 9, 2011 and must not have issued $1 billion or more of non-convertible debt during the previous three years. An issuer can remain an EGC for up to approximately five years following the issuer's IPO. The JOBS Act does not expressly define "total gross revenues" and this is not a generally accepted accounting procedures ("GAAP") financial measure. However, since enactment of the JOBS Act, SEC representatives have indicated they will use the GAAP term "total revenues." In addition, the SEC has indicated informally that the $1 billion debt ceiling will be determined based on the amount of debt the registrant has "issued" regardless of the amount of debt currently outstanding. This interpretation is based on the plain language of the JOBS Act. Accordingly, if a company has issued, either in public or private offerings, $1 billion in debt over an extended period, that company would not be entitled to EGC status. **Changes for IPOs and other registered offerings** The JOBS Act significantly changes the IPO process for EGCs, and also effects other changes to non-IPO registered offerings:

- Confidential Submissions. The JOBS Act will allow EGCs to submit draft registration statements to the SEC on a confidential basis. Historically, this privilege was afforded only to a foreign private issuer whose securities are listed or proposed for listing, on a non-U.S. stock exchange.

On April 10, 2012, the SEC issued a series of FAQs regarding the filing of confidential registration statements. The FAQs can be found at http://www.sec.gov/divisions/corpfin/guidance/cfjumpstartfaq.htm. Among other guidance, in these FAQs the SEC indicated that the filing of a confidential registration statement does not constitute a "filing" for the purposes of 5(c) of the Securities Act, and neither payment of the filing fee nor the filing of an auditor consent are required until the registration statement is publicly filed. Furthermore, a company that has publicly filed its registration statement that has not yet gone effective and that now qualifies as an EGC may "convert" to a non-public registration statement by contacting its review team at the SEC. Until the SEC modifies its EDGAR system, confidential filings should be made via CD or paper filing. Registration statements filed on a confidential basis may remain confidential for a period of time as determined by the issuer. However, the registration statement must be publicly disclosed at least 21 days prior to the date the issuer commences its roadshow. Care should be taken to ensure that most, if not all, SEC comments are adequately addressed prior to commencing the roadshow, because the registration statement will be public at that time. Furthermore, the SEC has informally advised that should additional issues arise after the registration statement has been made public but prior to its effectiveness, it reserves the right to make further comments. Issuers and underwriters should carefully schedule the timing of the roadshow and the public disclosure of the registration statement early in the offering process.

- Pre-filing communications. EGCs, and people acting on their behalf, are now permitted to engage in both oral and written communications with Qualified Institutional Buyers or accredited investors before filing a registration statement (as well as after filing) to determine the interest of investors in the contemplated offering. Such communications are excluded

from 5 of the Securities Act and thus will not result in "gun-jumping" violations. Written communications also need not be filed with the SEC as a free writing prospectus, but these communications will not be exempt from 12(a)(2) liability.

It remains to be seen how extensively issuers and underwriters will use these "test the waters" provisions. From an issuer's standpoint, there is little to no downside to taking advantage of these provisions. Issuers need to be thoughtful in these communications because the SEC has indicated it will review test-the-waters communications to determine if there is anything that should be included in the registration statement. Underwriters should ensure they are sufficiently protected from liability as a result of misstatements or omissions in any materials used. As an initial matter, underwriters must ensure they are considered a "person acting on an issuer's behalf" prior to contacting any investor, so that they are included in the gun-jumping protections. This can be accomplished by entry into an engagement letter or some other arrangement whereby it is clear the underwriter is acting on behalf of the issuer in contacting investors. Second, the underwriting agreement for an EGC offering should be amended to require the issuer to indemnify an underwriter for any information provided by the issuer during the pre-filing period that later is determined to contain a material misstatement or omission.

- Research Analysts and Research Reports. The JOBS Act now allows research analysts to publish reports about an EGC both before the filing of a registration statement and after its filing and effectiveness. This applies both to IPOs and other offerings. Publishing research reports was previously prohibited before the filing of the registration statement and for a period of time thereafter. Research reports now will not result in gun-jumping liability and will also not be subject to 12(b)(2) liability (although they remain subject to anti-fraud liability under Rule 10b-5). The JOBS Act expressly supersedes NASD rules that prohibit the publication of research reports with respect to IPO offerings but not rules related to non-IPOs. We expect that NASD will amend these rules to comply with the Act.

The JOBS Act also now permits research analysts to meet with management of an EGC with investment bankers present, an activity that was prohibited by NASD Rule 2711(c)(6). The JOBS Act supersedes this rule but does not supersede the Global Research Analyst Settlement in 2010 that prohibits certain investment banks from conducting meetings with clients at which research analysts are present. We anticipate that the investment banks subject to the settlement will jointly petition the court for relief in light of the JOBS Act. We expect that investment bankers will need to carefully consider the costs and benefits of taking advantage of these provisions. If bankers decide to use research reports, they will need to develop detailed procedures to ensure that no additional liability will be imposed on them, including limiting the distribution of reports to certain individuals. Many other NASD rules will continue to apply, such as the responsibility to disclose conflicts of interest. **Changes for Companies That Qualify as EGCs** In addition to changing certain aspects of the offering process for EGCs, the JOBS Act also gives EGCs relief from certain disclosure requirements under the Securities Act and the Exchange Act:

- EGCs are not required to comply with the auditor attestation over internal control requirements under 404(b) of the Sarbanes-Oxley Act. This exemption will remain in effect for as long as a company remains an EGC, but if a company qualifies as a "smaller reporting company" under SEC rules, it is exempt from 404(b) regardless of its status as an EGC. EGCs are not exempt from 404(a).
- EGCs will have to include only two years of audited financial statements and MD&A in their IPO registration statement. Also, EGCs will have to provide only selected financial data beginning with the earliest period for which audited financial statements are presented in the first effective registration statement. Current SEC rules require five years, notwithstanding the fact that audited financial statements are required for shorter periods.
- EGCs may elect to omit certain executive compensation items in their proxy statements, including the following:
    - Annual "say on pay" and "say on golden parachute" advisory votes
    - The upcoming requirement under the Dodd-Frank Act to disclose the relationship between executive compensation and company performance and the ratio of CEO pay to median employee pay
    - A compensation disclosure and analysis section
    - Disclosure of executive pay for all but the CEO and the two next-highest-paid officers
- EGCs, as long as they remain so, may elect on a one-time basis not to comply with new or revised accounting principles that apply to public companies, as long as they comply once the rules become applicable to private companies. The election must be made at the time the EGC files its first registration statement or periodic report with the SEC. Once the

election is made, it is irrevocable. EGCs also will not have to comply with Public Company Accounting Oversight Board rules regarding mandatory audit firm rotation and auditor discussion and analysis.

Conclusion Although most, if not all, EGCs undoubtedly will use the provisions of the JOBS Act related to executive compensation disclosure, it remains to be seen how the changes to the offering process will be implemented. For example, underwriters of EGC securities must decide if or to what extent they wish to use the JOBS Act's test-the-waters provisions. Care should be taken to ensure any materials used in connection with these communications are subject to full due diligence procedures and to indemnification by the issuer. Underwriters will also have to decide whether issuers should take advantage of the provisions requiring only two years of audited financial statements in registration statements and the relief from 404(b). Certain institutional investors may be prohibited by internal policies from investing in companies that take advantage of these provisions. Furthermore, representatives from the SEC have indicated they may seek additional disclosure in registration statements if the third year of audited financial statements includes unfavorable information about the issuer. Institutional investors may also have strong views about the ability of EGCs to elect to comply with new accounting rules in accordance with the same timetable applicable to private companies. We anticipate that the securities industry will eventually develop informal market standards that address most, if not all, of these issues. Until these develop, we recommend that both issuers and underwriters proceed with caution before taking advantage of these provisions.