LATHAM & WATKINS

Number 1308 March 27, 2012

Client Alert

Latham & Watkins Capital Markets Group

JOBS Act Establishes IPO On-Ramp

"The on-ramp established by Title I of the JOBS Act will make the IPO process significantly more attractive to most US and non-US issuers seeking to access the US capital markets and will provide many newly public companies with an eased transition to the public company regulatory regime."

Today, the House of Representatives passed the JOBS Act by a 380-41 vote. Last week, the Senate passed an identical version of the Act by 73-26. We expect President Obama to sign the JOBS Act into law in the coming days.

Title I of the JOBS Act grew out of the recommendations of the IPO Task Force, a national group of industry experts formed under the guidance of the US Department of the Treasury. Joel Trotter, a partner in our Washington, D.C. office, served as one of two securities lawyers on the IPO Task Force.[1]

The JOBS Act makes significant changes to the US securities laws that will make the IPO process more attractive to most US and non-US companies considering an IPO. Title I of the JOBS Act creates a new category of issuer, called an emerging growth company (EGC), that will benefit from a transition period, or on-ramp, from private to public company. During this period — which can last for up to five years — EGCs will be exempt from certain costly requirements of being a public company.

This *Client Alert* focuses on the IPO-related provisions of the JOBS Act and summarizes the key changes that will apply to EGCs. We also briefly describe the JOBS Act's elimination of prohibitions on general solicitation or general advertising in certain private offerings, as well as its changes to the 500-shareholder trigger of Section 12(g) of the Securities Exchange Act of 1934.

The Headlines

The Streamlined IPO Process

Title I of the JOBS Act will significantly streamline the IPO process for most companies seeking to go public. EGCs will benefit from the following changes to the IPO process:

- they will be able to make pre-filing offers to institutional investors;
- they will be permitted to initiate the registration process confidentially with the Securities and Exchange Commission;
- they will need only two, rather than three, years of audited financial statements to go public; and
- research analysts will be allowed to publish reports on EGCs immediately after they become public companies.

The IPO On-Ramp

Once public, an EGC will have a limited transition period of one to five years, depending upon the size of the company, during which the regulatory requirements will be scaled in order to ease the cost of compliance. During this on-ramp period, an EGC will be:

- exempt from Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires auditor attestation of internal control over financial reporting;

- exempt from the detailed narrative disclosure requirements of compensation discussion and analysis;
- exempt from the executive compensation voting requirements of the Dodd-Frank Wall Street Reform Act of 2010, including the requirement for say-on-pay, say-on-frequency and say-on-golden-parachute shareholder votes;
- exempt from the Dodd-Frank executive compensation disclosure provisions requiring the pay-for-performance graph and CEO pay ratio disclosure;
- subject to the longer phase-in periods that apply to private companies for any new or revised financial accounting standards; and
- exempt from any rules that the Public Company Accounting Oversight Board may adopt relating to mandatory audit firm rotation and any requirement to include an auditor discussion and analysis narrative in the audit report.

These changes will take effect immediately. The IPO-related provisions of the JOBS Act are self-executing and do not require any SEC rulemaking, although we expect the SEC to issue interpretive guidance and technical conforming changes to existing rules. Until that happens, uncertainty will remain about a variety of implementation issues. For example, we expect the SEC to adopt specific procedures for making confidential submissions to initiate the IPO process. We will keep you updated on key developments.

The Details

What Is an Emerging Growth Company?

To qualify as an EGC, a company must have annual revenue for its most recently completed fiscal year of less than $1.0 billion.[2]

After the initial determination of EGC status, a company will remain an EGC until the earliest of:

- the last day of any fiscal year in which the company earns $1.0 billion in revenue;
- the date when the company qualifies as a "large accelerated filer," with at least $700 million in public float;
- the issuance, in any three-year period, of more than $1.0 billion in non-convertible debt securities;[3] or
- the last day of the fiscal year ending after the fifth anniversary of the IPO pricing date.[4]

EGC status will ordinarily terminate on the last day of a fiscal year. However, the issuance in any three-year period of more than $1.0 billion in non-convertible debt securities would cause an issuer to lose its EGC status immediately.

EGC status is unavailable to any issuer that priced its IPO before December 9, 2011.

Key Changes to the IPO Process

Testing the Waters. Section 5 of the Securities Act, as revised by the JOBS Act, will permit EGCs and their authorized persons (including underwriters) to make oral or written offers to qualified institutional buyers and institutional accredited investors before or after the initial filing of a registration statement. This new provision significantly modifies the Section 5 restrictions on gun-jumping, and we expect pre-road show meetings with key institutional accounts to become a standard part of the IPO process.[5]

Confidential SEC Filings. EGCs will be permitted to initiate the IPO registration process confidentially by submitting to the SEC a draft registration statement for nonpublic review by the SEC Staff.[6] However, an EGC must hold its traditional IPO road show marketing process at least 21 days after publicly filing the initial submission and all amendments.[7]

Scaled Financial Disclosures. An EGC will be allowed to provide two, rather than three, years of audited financial statements at the time of its IPO.[8] After its IPO, the EGC will phase into full compliance by adding one additional year of financial statements in each future year until the EGC presents the traditional three years of audited financial statements plus two years of selected financial data. The required management's discussion and analysis of financial condition and results of operations will cover only the years for which audited financial statements are provided.[9]

Increased Availability of Research. The JOBS Act expands existing communications safe harbors to permit research analysts to cover EGCs sooner than was permitted under prior law and to permit additional interactions with research analysts during the IPO process.

- The principles underlying existing Securities Act Rule 139 have been extended to provide broker-dealers with an exclusion from the Securities Act definition of offer for research reports relating to EGCs.[10]
    - Similar to Rule 139, the new safe harbor provides that a broker-dealer's publication or distribution of research reports about an EGC will not constitute an offer, even if the broker-dealer is part of the syndicate for the offering.
    - However, this exclusion from the definition of offer operates independently of Financial Industry Regulatory Authority restrictions on whether a broker-dealer may publish or distribute research reports.
- The FINRA restrictions relating to post-offering research blackout periods under NASD Rule 2711(f) will no longer apply to post-IPO research reports in respect of EGCs, so that analysts may publish research on an EGC immediately following the IPO pricing date and without regard to the timing of expiration of any applicable issuer or shareholder lockup agreement. Although any pre-pricing analyst research reports would be excluded from the definition of offer under Section 5, the SEC or FINRA could expressly restrict research reports before and up to the IPO pricing date. Until there is further interpretive guidance or rulemaking by the SEC or FINRA, we recommend that underwriters presume that existing restrictions continue to prohibit pre-IPO publication or dissemination of research reports.[11]
- Current FINRA restrictions will be superseded such that research analysts will be permitted to meet with accounts or members of the EGC's management before the EGC files a registration statement and during the post-filing, pre-effective period, even if investment banking personnel are present or coordinate the meetings. This change dispenses with the formalistic distinctions that previously applied to those types of meetings.[12]

The JOBS Act does not amend the antifraud provisions of the US securities laws. All of the antifraud provisions will continue to apply to analyst research. In addition, the detailed and robust requirements developed in the last decade to address conflicts of interest between analysts and investment banking will continue to remain in effect unless otherwise revised or modified. These include Section 501 of Sarbanes-Oxley, analyst certification requirements under SEC Regulation AC and the comprehensive restrictions on analyst conduct, compensation, supervision and other matters under Rule 2711 and the Global Research Analyst Settlement of 2003 (which applies to certain of the largest investment banking firms). As a result, although we expect the JOBS Act to spur an increase in research coverage of newly public companies after the pricing date of their IPO, we do not expect to see research coverage initiated prior to the pricing of any IPO.

Elements of the IPO On-Ramp

As long as an issuer continues to qualify as an EGC, it will benefit from a temporary transition period, or on-ramp, during which its regulatory requirements will phase in gradually. This phased approach will ease the cost of public company compliance by allowing the EGC additional time to comply with some of the more costly requirements that apply broadly to the largest public companies. As discussed above, the on-ramp period for any particular EGC will depend upon its revenue, public float and issuance of debt securities but will not last beyond the last day of the fiscal year ending after the fifth anniversary of its IPO pricing date.

The on-ramp exemptions for EGCs cover five broad areas:

- *Section 404(b) of Sarbanes Oxley*. EGCs will be exempt from the auditor attestation requirements of Section 404(b) of Sarbanes-Oxley for as long as they qualify as EGCs.[13] Previously, all newly public companies, regardless of size, had until their second annual report to comply with Section 404(b), but only smaller reporting companies and non-accelerated filers received a permanent exemption. EGCs will be exempt for the duration of their on-ramp period.
- *CD&A*. EGCs will be permitted to dispense with the detailed compensation discussion and analysis narrative in registration statements and periodic reports and instead provide scaled executive compensation disclosure under the requirements that apply to smaller reporting companies.[14] In most cases, this will mean that EGC compensation disclosure will cover the top three, rather than the top five, executive officers and will include substantially reduced narrative disclosure.
- *Dodd-Frank Compensation Requirements*. The executive compensation provisions of Dodd-Frank do not apply to EGCs:
    - o EGCs will be exempt from the provisions of Dodd-Frank that require public companies to hold say-on-pay, say-on-frequency and say-on-golden-parachute shareholder votes. An issuer that loses its EGC status must hold an advisory vote on executive compensation within a year after ceasing to qualify as an EGC or, if later, by the end of the third year after its IPO.[15]
    - o In addition, EGCs will be exempt from the Dodd-Frank requirements regarding disclosure of a pay-for-performance graph and CEO pay ratio disclosure.
- *Extended Phase-In for New GAAP.* EGCs will not be required to comply with new or revised financial accounting standards until those standards also apply to private companies.[16] On occasion, new or revised accounting standards provide private companies with more lead time for compliance than public companies receive. This can occur with more complex standards that require significant data gathering or additional compliance personnel. An EGC will be permitted to follow the longer, private company phase-in period.[17]
- *Certain PCAOB Rules.* The PCAOB recently issued controversial concept releases on the subjects of whether the PCAOB should mandate audit firm rotation and an expanded narrative, called auditor discussion and analysis, that would appear as part of any financial statement audit. If the PCAOB decides to adopt rules regarding either of these requirements, EGCs will be exempt from those rules. In addition, no other

new rule that the PCAOB may adopt in the future will apply to an EGC unless the SEC determines that the new PCAOB rule is "necessary or appropriate in the public interest," after considering investor protection and "whether the action will promote efficiency, competition and capital formation."[18]

Private Offerings

The other Titles of the JOBS Act make a number of additional changes to the securities laws that will apply to all participants in the US capital markets. We note, in particular, three items that will facilitate private sales of securities in the United States:

- *General Solicitation Permitted in Certain Regulation D Offerings.* Title II of the JOBS Act directs the SEC to amend Securities Act Regulation D to eliminate the existing prohibition against general solicitation and general advertising for certain types of offerings.[19] In particular, general solicitation or general advertising will now be permitted for Securities Act Rule 506 transactions where securities are sold only to accredited investors. We believe this change should also cover private offerings that are structured to take advantage of both Regulation D and certain exceptions under the Investment Company Act of 1940, such as Section 3(c)(1) or 3(c)(7), provided that securities are sold only to "qualified purchasers" in reliance on the Section 3(c)(7) exception or fewer than than 100 beneficial owners in reliance on the Section 3(c)(1) exception.[20]
- *General Solicitation Permitted in Rule 144A Transactions.* Under Title II, the SEC must revise Rule 144A to provide that offers may be made to non-QIBs, including by means of general solicitation or general advertising, provided that securities are sold only to persons reasonably believed to be QIBs.[21]
- *Increase in the 500 Shareholder Trigger.* Titles V and VI of the JOBS Act amend the 500 shareholder trigger in Exchange Act Section 12(g). Under prior law, a company with more than $10 million in assets was required to register with the SEC and begin Exchange Act reporting within 120 days after the first fiscal year end at which it had a class of equity securities that was held of record by 500 or more persons. Under Title V of the JOBS Act, a company's obligation to register with the SEC and begin reporting will now be triggered following any fiscal year end at which the company has either 2,000 record holders of a class of equity securities or 500 record holders who are not accredited investors.[22] However, any employee who received securities under an employee compensation plan in a transaction exempt from registration under the Securities Act will not be counted for purposes of the shareholder trigger.

Conclusion

The on-ramp established by Title I of the JOBS Act will make the IPO process significantly more attractive to most US and non-US issuers seeking to access the US capital markets and will provide many newly public companies with an eased transition to the public company regulatory regime. We expect these reforms to encourage both US and non-US companies to take another look at issuing securities to the public in the United States. As these legal changes continue to play out, Latham & Watkins will provide updates on the SEC's interpretative guidance and new rulemaking, as well as answers to the key questions that arise for EGCs and their underwriters, financial sponsors and advisors as a result of the newly created IPO on-ramp.

Endnotes

[1] In March 2011, the US Department of the Treasury held a conference on access to capital, after which the IPO Task Force was formed with the purpose of recommending specific policy measures designed to increase US job creation and improve access to the capital markets for emerging growth companies. The IPO Task Force presented its report to the Treasury Department in October 2011. *See* "Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth" (Oct. 20, 2011), available at http://www.lw.com/page/IPOTaskForce. In December 2011, the recommendations of the IPO Task Force were largely adopted in two companion bills that garnered broad, bipartisan support in both the Senate and the House of Representatives.

[2] This new category of issuer is available to US issuers as well as foreign private issuers. *See* § 101(a) – (b).

[3] The statute, in a provision added by amendment to the original bill, refers in § 101 to "the date on which such issuer has, during the previous 3-year period, issued more than $1,000,000,000 in non-convertible debt," which should be read to refer to debt securities rather than bank debt. This concept derived from an element of the definition of "well-known seasoned issuer," which refers to the issuance of more than $1.0 billion in "aggregate principal amount of non-convertible securities, other than common equity." The IPO Task Force had recommended the use of WKSI status as a reference point for terminating EGC status, but the legislative text instead employed the definition of large accelerated filer to avoid potential manipulation of EGC status through the intentional loss of eligibility to use Form S-3 or Form F-3. The debt-related provision was then added back into the bill's definition of EGC later in the legislative process.

[4] § 101.

[5] § 105(c). The new provision, added as Section 5(d) of the Securities Act, provides: "Notwithstanding any other provision of this section [5], an emerging growth company or any person authorized to act on behalf of an emerging growth company may engage in *oral or written communications* with potential investors that are qualified institutional buyers or institutions that are accredited investors, as such terms are respectively defined in [Rule 144A] and [Rule 501(a)], or any successor thereto, to determine whether such investors might have an interest in a contemplated securities offering, *either prior to or following* the date of filing of a registration statement with respect to such securities with the Commission, subject to the requirement of subsection (b)(2) [to deliver a final prospectus]" (emphasis added).

[6] § 106(a). These confidential submissions are designated as materials that cannot be obtained through a request under the Freedom of Information Act.

[7] Under § 106(a), an EGC using the confidential submission process must publicly file its initial confidential submission and all amendments resulting from the SEC Staff review process "not later than 21 days before the date on which the issuer conducts a road show," as defined in Rule 433(h)(4). The requirement to conduct at least one road show not less than 21 days after public filing was intended to ensure that a traditional marketing process would still be ongoing at least three weeks after public dissemination of the original confidential submission to provide a meaningful time for interested parties to give their perspectives and insights on the publicly filed information well before the IPO pricing date. However, conducting "a road show" does not necessarily refer to the EGC's *first* road show. For example, an issuer that engages in testing the waters under § 105(c) might be deemed to have conducted a road show (within the broad definition of that term) before filing even its initial registration statement, but we believe that the Act clearly was not intended to require an EGC to choose between testing the waters and submitting filings confidentially, which is why the proviso in § 106(a) refers to "a road show" rather than "the first road show."

[8] § 102(b).

[9] § 102(c). We expect that, in Rule 144A offerings, EGCs will use the same financial statements that they would otherwise typically provide in a registered context.

[10] § 105(a). For a thorough review of the pre-JOBS Act issues surrounding offers under the Securities Act, see our *Client Alert*, "The Good, the Bad and the Offer: Law, Lore and FAQs," available at http://www.lw.com/page/thegood-thebad-theoffer.

[11] § 105(d). The continuing restrictions limiting pre-IPO publication or dissemination of research reports include current FINRA rules covering interactions between investment banking and analysts and rules prohibiting analyst participation in the solicitation of investment banking business and certain other offering-related marketing efforts.

[12] § 105(b).

[13] § 103.

[14] § 102(c).

[15] § 102(a). Under the transitional requirements in § 102(a), the executive compensation advisory votes must occur either (i) within the third year after the IPO of an issuer that was an EGC for less than two years after its IPO or (ii) otherwise, within one year after the issuer ceases to qualify as an EGC. In some cases, a technical application of these requirements could yield a different result than when applying the shorthand standard of "the later of three years post-IPO or one year post-EGC." This is because EGC status will often, but not always, terminate at year-end, whereas the IPO date may occur at any point during the year.

[16] § 102(b).

[17] An EGC may opt out of this extended phase-in period in its first filing. *See* § 107(b).

[18] § 104.

[19] § 201(a).

[20] The SEC has 90 days to revise Regulation D to implement these changes.

[21] The SEC has 90 days to revise Rule 144A to implement these changes.

[22] §§ 501-502. Title VI makes parallel changes to Section 12(g) for bank holding companies.

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