Milbank

Global Securities Group

Client Alert

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CONGRESS PASSES JOBS ACT - IMPLICATIONS FOR PRE-IPO COMPANIES AND PRIVATE OFFERINGS

On March 27, 2012, Congress approved the Jumpstart Our Business Startups Act (the "JOBS Act"). President Obama, who has expressed his support for the legislation, is expected to sign the JOBS Act into law. The new legislation garnered broad bipartisan support from Congress. The JOBS Act is intended to increase economic growth by improving access to the U.S. financial markets for both domestic and foreign companies and is expected to have a significant impact on the initial public offering ("IPO") process in the United States.

The new legislation lowers the costs and relaxes the rules of going public for most companies with annual revenues under $1 billion and reduces regulatory restrictions on private offerings and raises the thresholds triggering public company reporting. As a result of the reduced regulatory requirements, we expect that the JOBS Act reforms will facilitate more cost-efficient and quicker funding transactions.

Initial Public Offerings and Periodic Reporting Reforms

The JOBS Act includes provisions which aim to reduce the cost of going public by providing companies with less than $1 billion in annual revenues with a temporary reprieve from a number of Securities and Exchange Commission ("SEC") regulations by phasing in certain financial reporting regulations over a period of up to five years, including regulations related to compliance with the Sarbanes Oxley Act of 2002 ("Sarbanes-Oxley"), audited financial statement disclosure and "say on pay."

Definition – Emerging Growth Company

The JOBS Act creates a new class of companies called *Emerging Growth Companies* ("EGCs"), which are newly public companies (IPO registration statement effective after December 8, 2011) with less than $1 billion in annual gross revenues during their most recently completed fiscal year. The vast majority of pre-IPO companies qualify for EGC status: in 2011, 98 of 107 U.S. IPO companies had less than

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$1 billion in revenues, according to Dealogic. An EGC generally retains its status, and the associated reduced regulatory and reporting requirements, until the earliest of:

- the first fiscal year after its annual revenues exceed $1 billion;
- the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt;
- the first fiscal year in which it achieves "large accelerated filer" status (at least 12 months of reporting history and $700 million in public float); or
- the first fiscal year following the fifth anniversary of its IPO.

Newly Established Exemptions for EGCs

In an effort to encourage EGCs to go public in the U.S. markets, the JOBS Act exempts EGCs from a number of regulatory requirements during the period of up to five years during which they maintain EGC status (referred to as the "on-ramp" period), including:

Reduced Requirements under Sarbanes-Oxley

The JOBS Act exempts an EGC from providing auditor's attestation reports on its internal controls which would otherwise be required by Section 404(b) of Sarbanes-Oxley for the period of up to five years during which the EGC continues to be an EGC. A 2009 SEC survey reported a mean annual Section 404(b) compliance cost of $2 million. We expect that the reduced recurring compliance cost as a result of the JOBS Act reform will be well-received by EGCs and serve to lessen the burdens associated with being a public company.

Exemption from New Accounting Pronouncements and PCAOB Rules

An EGC is also exempted from complying with any new or revised U.S. GAAP accounting pronouncements applicable to public companies until the pronouncements are also specifically made applicable to private companies, and an EGC is exempted from future Public Company Accounting Oversight Board ("PCAOB") rules, including proposed rules relating to auditor rotation requirements.

Reduced Financial Information in Registration Statements and Exchange Act Reports

Under the reforms, an EGC need not provide more than two years (compared to the current three-year requirement) of audited financial statements in an IPO registration statement on Form S-1 or Form F-1. Likewise, an EGC need not provide selected financial data or management's discussion and analysis in subsequent SEC filings for any period prior to the earliest audited period presented in connection with its IPO.

Confidential Submissions of Draft IPO Registration Statements

The legislation permits an EGC, either domestic or foreign, to submit its IPO registration statement and subsequent amendments thereto on a confidential basis, provided a public filing is made at least 21 days prior to the offering road show. Historically, only foreign issuers were permitted to submit IPO registration statements on a confidential basis and, effective December 2011, the SEC further restricted confidential submissions to foreign issuers that meet specified conditions. Now, all EGCs will be eligible to make confidential submissions.

We expect EGCs to widely adopt the confidential submission process, which would permit an EGC to delay the disclosure of competitive information to the market and also reduce potential reputational harm associated with pulling the IPO should the company decide or market conditions so dictate.

"Test the Waters" Communications with Accredited Investors and Qualified Institutional Buyers

The legislation also expands permissible communications and meetings with accredited investors and qualified institutional buyers ("QIBs") before or after the filing of a registration statement to gauge investor interest in an EGC's securities without being subject to current restrictions on pre-offering oral and written communications. This provision is applicable to IPOs as well as other securities offerings by EGCs. We note that the new "test the waters" provisions, unlike existing provisions, do not contain a requirement to file with the SEC materials used to solicit investor interest, potentially creating the risk of uneven information among investors.

Reduced Executive Compensation Disclosure

The JOBS Act also: (i) permits an EGC to comply with the reduced executive compensation disclosure requirements generally available to smaller reporting companies; (ii) exempts an EGC from providing shareholders with an advisory vote on executive compensation (commonly referred to as "say-on-pay") and (iii) exempts an EGC from the Dodd-Frank Act requirement to disclose the ratio of CEO-to-worker pay compensation.

Increased Flexibility for Research Reports

The JOBS Act provides greatly increased flexibility to issue research reports by: (i) permitting brokers and dealers, including underwriters participating in any sale of equity securities of an EGC, including its IPO, to publish or distribute research reports regarding the issuer, or before or after effectiveness and commencement of the offering, and (ii) prohibiting the SEC and Financial Industry Regulatory Authority ("FINRA") from restricting research analysts from (a) issuing research reports or making a public appearance (such as on a TV talk show) or (b) participating in meetings with an EGC and investment banking personnel or restricting research about an EGC during a post-IPO quiet period or lock-up periods.

While the legislation allows brokers and dealers significant freedoms in distributing pre-IPO research, it is not clear how much advantage will be taken of this increased flexibility as a result of the continued application of Rule 10b-5 liability for misleading research reports and the history of litigation around this issue. Additionally, research analysts will still need to comply with the unaffected FINRA research rules, including the prohibition on participating in investment banking business solicitation and the certification that the research accurately reflects the analyst's personal views. Likewise, the SEC and FINRA will retain the ability to impose rules around research on matters not addressed by the JOBS Act. Finally, it remains unclear how the new legislation will affect the obligations of parties contractually bound by the terms of the Global Research Settlement.

Private Capital Formation Reforms

The JOBS Act contains a number of reforms aimed at easing the capital formation process for private companies, including requiring the SEC to implement a number of rules not later than 90 days after the effective date of the legislation. The reforms include the following provisions:

Removal of the Ban on General Solicitation and Advertising

General solicitation and advertising have previously not been allowed in private offerings. The JOBS Act removes this prohibition by eliminating the ban on general solicitation and advertising in connection with private offerings made pursuant to:

- Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act"), provided that all of the actual purchasers are accredited investors.
- Rule 144A under the Securities Act, provided that all of the actual purchasers are reasonably believed to be QIBs.

Under the new rules, private offerings will be able to be conducted concurrently with public offerings without violating publicity restrictions. Additionally, we would expect to see initial purchasers being named in press releases for private offerings.

Increase in the Threshold Triggering Public Company Reporting

Historically, many private companies have restricted their capital offerings due to the concern that a growing shareholder base would trigger public company reporting. The JOBS Act lessens this concern by allowing companies to raise private capital from a larger pool of investors without being required to file reports with the SEC. The reforms increase the numerical threshold triggering public company reporting by amending Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") by:

- Raising the public company reporting trigger for companies which have not yet completed an IPO to $10 million in assets and 2,000 shareholders (compared to the current 500 shareholder maximum), provided that fewer than 500 of such shareholders are non-accredited investors.
- Raising the public company reporting trigger for banks and bank holding companies to $10 million in assets and 2,000 shareholders (compared to the current 500 shareholder maximum), and permitting public banks or bank holding companies to terminate their Exchange Act reporting requirements if they have fewer than 1,200 shareholders of record (compared to the current 300 shareholders requirement).
- Excluding from the calculation of the number of shareholders any shareholders receiving securities under equity compensation plans. Additionally, the SEC is directed to exclude from this calculation, conditionally or unconditionally, shareholders acquiring securities pursuant to the "crowdfunding" exemption discussed below.

A shareholder base approaching 500 has been considered a major factor in a company's decision to go public and the larger shareholder base permitted by the JOBS Act will provide companies with the flexibility to stay private for a longer period of time. However, because some investors, such as venture capital and private equity investors, might wish to monetize their holdings prior to the IPO, combined with the permitting of general solicitation described above, we expect the JOBS Act to potentially increase trading of private companies on secondary markets.

Expansion of the Regulation A Small Offering Exemption

The JOBS Act amends Regulation A under the Securities Act, which currently exempts from registration small offerings, by increasing the amount of securities that can be issued pursuant to that exemption over a 12-month period from $5 million to $50 million. Issuers do not subject themselves to periodic reporting obligations under the Exchange Act by conducting an offering in reliance on this exemption absent exceeding the threshold number of shareholders which would otherwise trigger reporting as a public company under the Exchange Act. However, issuers relying on the Regulation A exemption will be required to file audited annual financial statements with the SEC. Furthermore, unless the securities offered pursuant to the expanded Regulation A exemption are offered or sold on a national securities exchange, such offerings will be subject to state blue sky securities laws.

Creation of a New Exemption for "Crowdfunding" Transactions

The JOBS Act amends Section 4 of the Securities Act to create a new registration exemption for "crowdfunding" (an acronym for Title III of the JOBS Act, which is referred to as the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012," or the "CROWDFUND Act"). The new crowdfunding exemption permits a non-reporting company to raise up to $1 million within any 12-month period with greatly reduced legal cost and without needing to limit itself to accredited investors. An issuer would be limited to seeking a maximum investment per investor of:

- the greater of $2,000 or five percent of the investor's annual income or net worth within any 12-month period (if either the investor's annual income or net worth is less than $100,000); and
- 10 percent of the investor's annual income or net worth, not to exceed a maximum amount of $100,000 (if either the investor's annual income or net worth is equal to or more than $100,000).

An eligible "crowdfunding" must meet certain requirements, including that all offers and sales must be conducted through a broker or a "funding portal" (defined as an intermediary which registers with the SEC and meets certain conditions, including not offering investment advice, not soliciting and not compensating employees based on sales), no advertising is permitted other than notices directing investors to the broker or funding portal and certain information is furnished to the SEC, the broker or funding portal and investors, including a description of the issuer's business, business plan, risk factors and financial condition (together with audited financial statements if offerings over a 12-month period exceed $500,000). Securities offered in crowdfunding transactions are also exempt from registration under state blue sky securities laws and, while subject to certain resale restrictions for one year, may be resold freely to accredited investors. Finally, the legislation directs the SEC to adopt rules to conditionally or unconditionally exclude from the calculation of shareholders which could trigger public company reporting shareholders who acquire shares in crowdfunding transactions.

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