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The JOBS Act: Implications for Capital Markets Professionals, Pre-IPO Companies and Private Offerings

On March 22, 2012, the Senate passed the Jumpstart Our Business Startups Act (the "**JOBS Act**"), in substantially the same form passed by the House of Representatives on March 8, 2012, amending only the portions of the bill relating to $1-2 million "crowdfunding" offerings in order to address investor-protection concerns. The JOBS Act will now return to the House for approval as early as tomorrow, at which point it will only need President Obama's signature to become law.

The JOBS Act, if passed, will represent the most significant legislative loosening in memory of restrictions around the IPO process and public company reporting obligations.

We summarized the key provisions of the JOBS Act in our March 9 memorandum, *Quicker to Market? U.S. House of Representatives Passes the Jumpstart Our Business Startups Act*. This memo takes a more detailed look at some of its provisions, focusing on those that would:

- significantly relax the rules relating to IPOs by emerging growth companies ("**EGCs**," or companies with less than $1 billion in total annual gross revenues) by permitting them to avoid Sarbanes-Oxley 404 requirements for up to five years, file confidentially and comply with fewer rules;
- significantly relax the limits on the publication by investment banks of research related to an EGC around the time of its IPO;
- significantly relax the rules prohibiting publicity around private offerings by all companies, while also permitting pre-filing offers by an EGC in connection with its IPO; and
- increase shareholder numerical thresholds that trigger public company registration under the Securities Exchange Act of 1934.

Facilitating IPOs and Relaxing Public Reporting Requirements

The JOBS Act would ease the IPO process for EGCs in several ways:

- **Pre-Filing Marketing** – EGCs would be able to hold meetings with institutional accredited investors and qualified institutional buyers to "test the waters" – or gauge investor interest in their securities prior to an offering – without being subject to current restrictions on pre-offering communications.[1]
- **Confidential Filings** – EGCs would be permitted to file their IPO registration statement on a confidential, nonpublic basis for review by the SEC, so long as the confidential submission is publicly filed 21 days before the "road show" (which is very broadly defined).

[1] There is a potential inconsistency between the ability of an EGC to conduct pre-marketing and the 21-day condition described in the next bullet should the EGC decide to file its IPO registration statement on a confidential, nonpublic basis, given the very broad definition of "road show." That definition would include any presentation by management of the EGC but not a presentation by its advisers. This means that if an EGC decides to file its IPO registration statement on a confidential, nonpublic basis, the ability of its management to conduct pre-marketing more than 21 days before the public filing would continue to be limited, even though the EGC's advisers would not be so limited. We expect the SEC to clarify this potential inconsistency. *[Note: The SEC staff clarified this inconsistency through guidance issued in April 2012, indicating that testing-the-waters pre-marketing need not be treated as the "road show" for purposes of the 21-day condition described above.]*

- **Audited Financial Statements** – EGCs would need to provide only two years (not three years, as is the current requirement) of audited financial statements in their IPO registration statement. In addition, "selected financial data" for prior periods would not be required.

The JOBS Act would also relax the public reporting requirements for an EGC for the first five years following its IPO (unless it no longer continues to satisfy the EGC definition), as follows:

- **Sarbanes-Oxley Section 404(b)** – An EGC would not be required to provide an auditor's attestation report on its internal controls.
- **Executive Compensation** – An EGC would not be required to hold shareholder advisory votes on executive compensation, or disclose certain executive compensation information required for other companies, such as a comparison of executive pay to performance and median compensation.
- **New U.S. GAAP Rules** – An EGC would not be required to comply with new GAAP accounting pronouncements applicable to public companies until the pronouncements are also applicable to private companies.
- **New PCAOB Rules** – An EGC would not be required to comply with any future PCAOB rules mandating auditor rotation, or requiring a supplement to the auditor's report covering additional information about the audit and the financial statements.

We expect that all of these changes by the JOBS Act will help smaller companies access the U.S. capital markets, and make the burdens associated with becoming a public company more palatable. In particular, for EGCs we expect that these changes will reduce the actual costs associated with conducting an IPO. We also expect that EGCs will take advantage of the ability to hold meetings with institutional accredited investors and qualified institutional buyers prior to an IPO and to file their IPO registration statement on a confidential, nonpublic basis. These options would permit an EGC to explore an IPO without disclosing sensitive competitive information to the market, and avoid any embarrassment associated with pulling the IPO should the company so decide. We expect the recurring costs associated with being a public company after an IPO to be reduced for an EGC, most significantly as a result of not having to comply with Sarbanes-Oxley Section 404(b). For all of these reasons, we expect these changes by the JOBS Act to be well received by companies that meet the EGC definition.

Research

Three Significant Changes

Under current law, investment banks participating in an IPO may not publish research in advance of the IPO. Once the IPO is priced, their research analysts may not publish until 40 days following the offering, and then must cease publishing for the 15 days before and after the release or expiration of any lock-up agreement. In addition to these rules, a number of other rules apply to ensure that research is independent of investment banking and is not used to solicit investment banking business.

The JOBS Act would make three significant changes to current law (and possibly current practice) regarding the role of research analysts around the time of an EGC's IPO. It would:

- permit publication of a research report related to an EGC prior to a proposed IPO by that company;
- require FINRA to rescind its rules restricting a research analyst from participating in meetings with an EGC alongside investment banking personnel; and
- require FINRA to rescind its rules prohibiting research about an EGC during any particular period of time following either its IPO or the expiration of any lock-up period related to its IPO.

More Limited Sources of Liability for Research

Because of the legislative drafting path Congress is taking to permit research related to an EGC, investment banks will be permitted to distribute pre-offering research, and this research would not be subject to liability under the Securities Act of 1933 – the strictest form of investor liability under the federal securities laws. While the JOBS Act would not leave an investor without any U.S. federal remedy for misleading research – particularly misleading research published by a syndicate member – the investor would have to bring the action under Rule 10b-5, which would require a showing that the syndicate member knowingly intended to mislead, or was at the very least reckless.

It is not clear that investment banks will take advantage of this flexibility, at least for now. While pre-deal research is common outside the United States, the U.S. litigation environment is unique. After the late 1990's "dot-com craze," investment banks paid sizable amounts to settle Rule 10b-5 claims where the research in question allegedly contained misstatements. If pre-deal research is used in the context of IPOs that fail to perform in the aftermarket, it could attract similar lawsuits. In this regard, we note that in 2005 the SEC permitted banks to use "free writing prospectuses" to market IPOs, but banks have generally not taken advantage of this flexibility.

FINRA Will Be Required to Relax Its Rules

FINRA currently enforces a number of rules restricting the activities of research analysts. These include, among others, prohibitions on research analysts participating in efforts to solicit investment banking business and prohibitions on publishing or distributing research reports for specified periods of time following an IPO or a follow-on offering, and following the expiration of related lock-up periods. These rules were implemented in the wake of several high-profile investigations in 2002 and 2003 into the practices of research analysts and their role in procuring investment banking business. The intent of these rules was to preclude conflicts of interest, among other ways by prohibiting investment banks from competing for business on the basis of favorable research.

Now, analysts would not be subject to these blackouts for EGCs, and can meet together with investment banking personnel. (There have been several vocal critics of this aspect of the JOBS Act, including SEC Chairman Mary Schapiro.)

That said, the JOBS Act would not eliminate all restrictions on research related to EGCs. For example, research analysts would still need to comply with the unaffected provisions of FINRA's research rules, including the prohibition on participating in efforts to solicit investment banking business, and with Regulation AC, which requires research analysts to certify that the views they express in their research reports accurately reflect their personal views. It is unclear what the ongoing status of the Global Research Settlement will be in light of the JOBS Act's mandated changes to SEC and FINRA research rules. To the extent that the Global Research Settlement is still applicable, it includes restrictions, such as a prohibition on research analysts participating in pre-marketing, that could limit the ability of firms that are party to the Global Research Settlement to take advantage of some of the flexibility contained in the JOBS Act. Still, the amendments should relax restrictions on research prior to offerings and roadshows by EGCs. (Although NYSE Rule 472, which imposes restrictions on research, is not technically affected by the JOBS Act, we believe the NYSE is likely to amend Rule 472 to conform with FINRA's changes to its research rules.)

Possible Reaction by the SEC

As noted above, the SEC Chairman has expressed criticism of certain aspects of the JOBS Act, including those relating to research. While it is impossible to know what, if any, action the SEC could take in response to the enactment of the JOBS Act, we expect the SEC will likely issue guidance reminding banks of the research rules not implicated by the JOBS Act. In addition, the SEC and FINRA will retain the power, if either chooses, to impose rules around research on matters that are not addressed by the JOBS Act. These rules could include, for example, an obligation to file research on EDGAR.

General Solicitation and Other Consequences for Private Offerings

The JOBS Act would permit widespread advertising and other forms of "general solicitation" in private offerings in reliance on Regulation D or Rule 144A under the Securities Act of 1933, so long as all actual purchasers of the securities are accredited investors (under Rule 506 of Regulation D) or QIBs (under Rule 144A). Today, advertising is not permitted in private offerings, but it is permitted (though not widely used) in public offerings registered with the SEC. That distinction would no longer matter. Unlike other aspects of the JOBS Act, this change would apply to all issuers.

In theory, this would permit companies and their advisers to use most of the tools of Madison Avenue to find investors in private offerings, including placing newspaper, Internet or TV ads, so long as the buyers all end up being accredited investors or qualified institutional buyers. We do not expect that this will occur, at least not in the near term. However, we do expect to see a number of practical consequences immediately:

- The initial purchasers or placement agents would be able to be named in press releases for a private offering conducted in reliance on Rule 506 of Regulation D or Rule 144A.
- A company conducting a public offering would be able to conduct a concurrent private placement without concerns about publicity restrictions. As a result, companies would have previously unavailable flexibility to raise capital on a registered basis, a private basis or both.

In private offerings, the JOBS Act may change market practice for audited financial statements. Historically there has been a strong preference to include three years of audited financials in a Rule 144A offering memorandum, consistent with the requirement in a registered offering. Because the JOBS Act would permit EGCs to provide only two years of audited financials in their registration statements, market practice may move to including only two years in an offering memorandum for an issuer (including one that is not an EGC) that is conducting an offering on a private basis.

Increased Shareholder Numerical Thresholds for Public Company Reporting

The JOBS Act would also increase the shareholder thresholds that trigger public company reporting obligations for companies that have not yet completed an IPO, by providing that an issuer is not required to register with the SEC until it has a class of equity securities held of record by either 2,000 shareholders or 500 shareholders who are not accredited investors. The JOBS Act would exclude shareholders who received their securities pursuant to an employee compensation plan. Moreover, despite attempts at reform, the rules regarding DTC and its direct participants would remain unchanged by continuing not to count the potentially thousands of beneficial holders who hold through DTC.

This change would provide issuers, including large issuers that are not EGCs, with the flexibility to stay private for a much longer period of time and generate a much larger shareholder base before conducting an IPO. It is unclear what effect this change could have, if any, on the secondary trading market for shares of privately held companies. But, we expect that this flexibility, coupled with the flexibility described above for EGCs to do pre-filing marketing, could result in a significant increase in trading on private secondary markets, such as SecondMarket and SharesPost, and lead to further developments in secondary market trading of private companies.

Effectiveness

The portions of the JOBS Act relating to EGCs would turn on when the "first sale" of its "common equity securities" took place pursuant to an effective registration statement under the Securities Act of 1933. If this first sale occurred on or before December 8, 2011, then the company would not qualify as an EGC. This means that if a company is currently in registration with the SEC but its IPO has not yet priced, or it priced its IPO after December 8, 2011, then it would be able to avail itself of the relaxed requirements under the JOBS Act, assuming the company otherwise meets the definition of an EGC.

For the portions of the JOBS Act relating to private offerings, the SEC would be required to revise its rules to give effect to these changes not later than 90 days after the JOBS Act is enacted.

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The JOBS Act continues to enjoy broad bipartisan backing, including support from the White House, as a result of the many reforms it contains that would make it more attractive for smaller companies to access the U.S. capital markets. As a result, we expect that the JOBS Act will be signed into law by the President very shortly after the House and the Senate agree on a single version, perhaps as early as tomorrow.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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