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Alert

Corporate & Securities

The JOBS Act – Where Are We Now – 2014?

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On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups Act (the "**JOBS Act**") into law.[1] The stated purpose of the JOBS Act was to increase job creation and stimulate economic growth.[2] Often referred to as the "IPO on-ramp," the JOBS Act was enacted in part to improve access to public capital markets by alleviating, or in some instances eliminating, some of the restrictions placed on a new category of companies called "emerging growth companies"[3] ("**EGCs**") during the initial public offering ("**IPO**") process.

Market Overview 2013/2014 Since the passage of the JOBS Act, the U.S. IPO market has strengthened significantly. In fact, 2013 was a record year for the U.S. IPO market—the best since 2000—with a total of 222 companies going public, generating approximately $55 billion in proceeds.[4] By comparison, in 2012, roughly 128 companies completed an initial public offering, generating approximately $43 billion in proceeds.[5] In the last quarter of 2013 alone, 70 companies priced IPOs – more than any other quarter that year.[6] In 2013, the average U.S. IPO return rate was a staggering 41% compared to an average return rate of 21% in 2012.[7] For the first time since 2004, the North American region (the United States and Canada) surpassed other regions, including the Asia Pacific region, with roughly a 29% gain in proceeds raised and an average return of approximately 26%.[8]

The JOBS Act may not be the only driving force behind the recent surge in U.S. IPO activity though. BDO USA, LLP ("**BDO**"), one of the nation's leading accounting firms, conducted an annual survey of capital markets executives, which concluded that other factors may have contributed to the rise in IPO debuts. Such factors include (i) lower interest rates (increasing investor demand for high-yielding assets), (ii) increased confidence in the U.S. economy, and (iii) successful offerings by other companies. No matter the reason, it remains

undisputed that IPO performance in 2013 was impressive, beating benchmark indices, with an average return rate of 41%.

According to quarterly data published by another leading accounting firm, so-called "EGCs" accounted for approximately 81% of all IPOs that priced in 2013. Below are some reforms made available to EGCs navigating the IPO process under the JOBS Act. An EGC usually consults its counsel and the underwriters to determine of which options it should avail itself based on the unique characteristics of the company.

- Confidential submission of draft registration statement.
- The option to make limited disclosures or rely on exemptions from certain disclosure requirements for up to five years following an EGC's IPO, including limited executive compensation disclosure requirements.
- Exemption from the requirements under section 404(b) of the Sarbanes-Oxley Act of 2002 (the "**Sarbanes-Oxley Act**") to have an auditor attest to the effectiveness of the EGC's internal control over financial reporting.
- Presentation of two years of audited financial statements, as opposed to the three-year requirement applicable to non-EGCs.
- Allowing both oral and written communications with qualified institutional buyers ("**QIBs**") and institutional accredited investors before or after the filing of a registration statement to gauge interest in the offering.
- Allowing broker-dealers to publish or distribute a research report regarding the securities of an EGC.
- Taking advantage of an extended transition period for complying with any new or revised standards issued by the Financial Accounting Standards Board to its Accounting Standards Codification.
- Refraining from conducting "say-on-pay" votes at initial annual meetings.

Confidential Submission of Registration Statements Section 6(e) of the Securities Act of 1933, as amended (the "**Securities Act**"), provides that an EGC may confidentially submit a draft registration statement to the U.S. Securities and Exchange Commission (the "**SEC**") for review by the SEC's staff prior to public filing. However, the registration statement must be publicly filed at least 21 days before the issuer starts the road show process.

While evidence shows that a vast majority of EGCs that completed an IPO in 2013 took advantage of the opportunity to confidentially submit a draft registration statement, others chose to file their registration statements publicly, either to drum up early investor interest or to avoid potential delays prior to launching the road show.

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One benefit to confidentially submitting a draft registration statement prior to publicly filing a registration statement is that it allows an EGC to begin the review process with the SEC without prematurely revealing sensitive information about the company, such as growth plans, business strategies, or financial data. In addition, it allows the company to postpone or terminate its IPO efforts outside of the public eye. This way, potentials investors are less likely to know if the company failed in its IPO attempt.

Practice Tips

- If an EGC chooses to confidentially submit a draft registration statement, it does not need to be signed and does not need to include the consent of the auditors or other experts, as the submission does not constitute a filing. However, the SEC *does* expect a draft registration statement to be "substantially complete" at the time of confidential submission (*i.e.*, an EGC must include a signed audit report of an independent registered public accounting firm covering the fiscal years presented in the draft registration statement).[9]
- Because a confidential submission is not a filing, EGCs do not need to pay SEC filing fees when they confidentially submit draft registration statements. Rather, SEC filing fees are paid with the first public filing. However, confidential submissions do trigger Financial Industry Regulatory Authority ("**FINRA**") filing requirements and the payment of FINRA's applicable filing fee (unless no FINRA member broker-dealer is yet involved in the offering) if an underwriter is named in the registration statement.
- An EGC that has filed its registration statement confidentially may issue a press release informing the public of such filing in accordance with Rule 135 under the Securities Act. Some companies that have issued such press releases include Twitter, GoPro, and SunEdison, to name a few.

Exemption from Certain Executive Compensation Disclosure Section 102 of the JOBS Act allows EGCs to forego certain disclosure requirements regarding executive compensation that are outlined in Item 402 of Regulation S-K. For example, an EGC can omit (i) the "Compensation Discussion and Analysis" section of a registration statement (which discusses the compensation awarded to, earned by, or paid to certain executive officers) and (ii) the "Grants of Plan-Based Awards" table, the "Option Exercises and Stock Vested" table, the "Pension Benefits" table, and the "Nonqualified Deferred Compensation" table. In essence, an EGC complies with the requirements outlined in Item 402 of Regulation S-K if it complies with the requirements for "smaller reporting companies," even if it does not otherwise qualify as one. A majority of the EGCs that completed initial public offerings in 2012 and 2013 opted for this reduced approach to executive compensation disclosure.

Practice Tips

- Once a company goes public, potential investors and future shareholders closely monitor its executive compensation practices. Therefore, it is necessary for EGC issuers to consider carefully whether it makes sense to add less disclosure initially when it comes to executive compensation.

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- EGCs *are* required to provide compensation disclosure for three named executive officers (the CEO and the two other highest-paid executives), whereas non-EGCs must disclose the compensation levels for five named executive officers (the CEO, the CFO, and the three other highest-paid executives).

Exemption from Section 404(b) of the Sarbanes-Oxley Act Under the Sarbanes-Oxley Act, the management of public companies must assess the effectiveness of the company's internal control over financial reporting.[10] It also requires that the company's auditor report on management's assessment of its internal controls.[11] But Title I of the JOBS Act exempts EGCs from auditor attestation of its internal control over financial reporting.

Non-accelerated filers (companies with a public float below $75 million) are also exempt from the Sarbanes-Oxley requirement of providing auditor attestation of its internal control over financial reporting under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**").

Practice Tips

- Despite being able to rely on an exemption to section 404(b) of the Sarbanes-Oxley Act, EGCs must still comply with section 404(a) of the Sarbanes-Oxley Act, which requires management to assess the effectiveness of the company's internal control over financial reporting on its second annual report on Form 10-K.

Exemption from Full Financial Disclosure In our experience, many EGCs opt to take advantage of reduced financial statement disclosure requirements in their registration statements. The table below compares the requirements for EGCs and non-EGCs:

EGCs	Non-EGCs
Two Years of Audited Financial Statements	Three Years of Audited Financial Statements
As little as Two Years of Unaudited Selected Financial Data	Five Years of Unaudited Selected Financial Data

Three years of audited financial statements are required to be included in an EGC's annual report on Form 10-K. Even so, an EGC is not required to include audited financial statements for any period prior to the earliest audited period presented in connection with its IPO.[12]

It should be noted that some EGCs choose not to take advantage of the optional reduced financial statement disclosure requirements, believing that the benefits do not outweigh the possible perception by potential investors that the company is not ready for the burdens of being a public reporting company.

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Basic Guidelines for "Test-the-Waters" Communications

The lead underwriter usually has detailed procedures for "test-the-waters" communications. Common practices for these communications include:

- Communications may only be with QIBs and/or institutional accredited investors.
- No written materials or handouts should be used.
- Presentation materials should not be emailed or viewable except in person.
- The presentation and answers to anticipated questions should be scripted.
- Content must be factual, balanced and not misleading.
- Historical financial information is permitted, but projections are not.
- General valuation concepts may be discussed, but binding indications of interest may not be solicited.
- No media members may attend investor meetings, and no broadcasts or recordings may be made.
- Presentation materials and scripts should be reviewed in advance by counsel, and supplementally provided to the SEC.

Practice Tips

- If an EGC presents two years of audited financial statements, it must present at least two years of unaudited selected financial data. If an EGC chooses to present more than two years of audited financial statements, then its unaudited selected financial data must match the same number of years.

Leeway to "Test the Waters" Section 5 of the Securities Act prohibits certain communication regarding the sale of securities without an effective registration statement. However, EGCs and their underwriters (or other authorized persons) may engage in oral or written communications with QIBs and institutional accredited investors in order to assess a potential investor's interest in the offering. How many EGCs "test the waters" with early communications is unclear, as this practice is still developing with investment banks and these communications are not typically filed with the SEC.

Practice Tips

- Antifraud provisions of the federal securities laws apply to the content of "testing-the-waters" communications.
- The SEC frequently asks EGCs for copies of any materials used to "test the waters" in comment letters. Therefore, EGCs must ensure that "testing-the-waters" communications conform to statutory prospectus disclosure requirements.

Ability to Publish Research Reports Broker-dealers for EGCs may issue research reports regarding these companies. This is significant in that a "research report" is now excluded from the definition of an "offer" to sell a security, which is prohibited without an effective registration statement. A "research report" includes any "written, electronic, or oral communication that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."[13]

Despite this exception to the prohibition on offers to sell securities, underwriters for EGCs do not appear to be actively publishing research reports before or during an IPO. Rather, it seems as though underwriters continue to follow the traditional notion that research should not be published until 25 days after the expiration of the initial prospectus delivery period.[14]

Practice Tips

- Similar to "testing-the-waters" communications, the SEC often requests copies of any research reports published or distributed by broker-dealers for EGCs. Therefore, it is important to be mindful of the content of these reports.

Flexibility in Complying with Accounting Standards While EGCs are not required to "comply with any new or revised financial accounting standards until" private companies are required to comply with any new GAAP standards, it appears as though only a few EGCs are taking advantage of the lengthier transition period for new or revised financial accounting standards.[15]

> ***Practice Tips***
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> - Once an EGC decides to take advantage of this exemption, it can decide not to at any time (*i.e.*, comply with accounting standards applicable to non-EGCs). However, if an EGC initially decides to "opt out" of this exemption, the decision is final.
> - If an EGC decides to avail itself of this exemption, it must state in both the risk factor section and the critical accounting policies section of the registration statement that financial statements may not be comparable to those of companies that comply with public company requirements.

No "Say-on-Pay" Vote Requirement EGCs are not required to comply with the "say-on-pay" provisions of the Dodd-Frank Act, and do not have to conduct "say-on-pay" votes for a minimum of three years. As of May 2013, only 24% of EGCs had conducted say-on-pay votes at initial annual meetings.[16]

> ***Practice Tips***
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> - Once a company is no longer considered an EGC, a "say-on-pay" vote is required at the first annual meeting after losing EGC status. If a company loses its EGC status within the first two years after its IPO, a "say-on-pay" vote is required the third year following its IPO.

Industries According to industry research, the energy, financial, technology, and health care sectors were among the most active sectors in 2013 in terms of IPO proceeds raised. The health care sector had its biggest year in 2013, with 54 life sciences companies completing an IPO—only nine of which ended the year trading below their issue price.[17] The technology sector fell just below the health care sector in terms of the number of companies that completed an IPO, with a total of 45 companies going public.[18] To date, life sciences companies continue to dominate the IPO market.

Going Forward: What to Expect in 2014 With a building backlog of IPOs, 50 new IPO public filings in 2014 already made (a 194% increase from last year during the same period), and economic indicators continuing to improve, the capital markets community expects continued growth and strong performance of IPOs in 2014. During the first two months of 2014, more than 35 IPOs have priced, representing a 75% increase from last year, and the average IPO return has been approximately 24% from its offer price.

We expect it to be another strong year for IPOs. Some industry experts are predicting that total IPO proceeds will be at least $66 billion and that there will be

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a 9% increase in the number of U.S. IPOs in 2014. Although the health care sector has been particularly active so far this year, we expect a terrific year from the technology sector in 2014 as well, with some companies like GoPro, King Digital, and Coupons.com coming to market.

Reed Smith LLP will continue to monitor the impact of the JOBS Act on U.S. public capital markets in 2014 and review proposed amendments to or additional legislation affecting the JOBS Act.

Endnotes

[1] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. (Apr. 5, 2012) (the "JOBS Act").

[2] *Id.*

[3] The Securities Act of 1933, as amended (the "Securities Act"), defines an EGC as an issuer with "total annual gross revenues" of less than $1 billion during its most recently completed fiscal year. Once a company is an emerging growth company, it will remain one until the last day of the fiscal year in which it has total annual gross revenues of $1 billion or more or the last day of the fiscal year following the fifth anniversary of its IPO.

[4] Renaissance Capital, *US IPO Market, 2013 Annual Review*, January 2, 2014 (the "Renaissance Capital 2013 Annual Review").

[5] *Id.*

[6] Renaissance Capital, *Global IPO Market, 2013 Annual Review*, December 18, 2013.

[7] Renaissance Capital 2013 Annual Review; Renaissance Capital, *US IPO Market, 2012 Annual Review*, January 2, 2013.

[8] *Id.*

[9] U.S. Securities and Exchange Commission, *Jumpstart Our Business Startups Act Frequently Asked Questions – Confidential Submission Process for Emerging Growth Companies* (April 10, 2014), http://www.sec.gov/divisions/corpfin/guidance/cfjumpstartfaq.htm.

[10] American Institute for CPAs, *Section 404(b) of Sarbanes-Oxley Act of 2002*, http://www.aicpa.org/advocacy/issues/pages/section404bofsox.aspx.

[11] *Id.*

[12] U.S. Securities and Exchange Commission, *Jumpstart Our Business Startups Act Frequently Asked Questions – Generally Applicable Questions on Title I of the JOBS Act* (September 28, 2012, May 3, 2012, and April 16, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

[13] 15 U.S.C. §77(b)(3).

[14] *The Wall Street Journal*, *IPO Quiet Time: Banks Can't Let Go* (August 20, 2012), http://online.wsj.com/news/articles/SB10000872396390444233104577591773919525202.

[15] The JOBS Act.

[16] Bloomberg Law, *Study Finds Start-Up Firms Using Relaxed JOBS Act Disclosure Rules*, Securities Regulation & Law Report, The Bureau of National Affairs, Inc. (May 13, 2013).

[17] Renaissance Capital 2013 Annual Review.

[18] *Id.*

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