

JOBS Act Quick Start

A brief overview of the JOBS Act
2014 Update

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About the firm

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Introduction

Many market participants were taken by surprise by the enactment of the Jumpstart Our Business Startups Act. The JOBS Act, HR 3606, was passed by the United States House of Representatives on March 8 2012. On March 22, the Senate passed HR 3606 with an amendment to Title III (providing for the crowdfunding exemption with enhanced investor protections). On March 27, the House of Representatives accepted the Senate's amendment, and on April 5, President Obama signed the JOBS Act into law. To many, this may sound like a quick path for legislation, especially when considered in the context of a Congress that seemed virtually deadlocked and unable to reach the consensus required to take action on pressing issues. When considered closely and in context, however, it becomes clear that the Act was the culmination of an at least year-long bipartisan effort in both the House and Senate to address concerns about capital formation and unduly burdensome Securities and Exchange Commission (SEC) regulations.

The JOBS Act affects both exempt and registered offerings, as well as the reporting requirements for certain public issuers. A centerpiece of the Act is a new IPO on-ramp approach for a class of emerging growth companies (Title I), with confidential SEC staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on test-the-waters communications with qualified institutional buyers (QIBs) and institutional accredited investors before and after filing a registration statement, and fewer restrictions on research (including research by participating underwriters) around the time of an offering. In addition, the JOBS Act directs the SEC to amend its rules to:

- eliminate the ban on general solicitation and general advertising in Rule 506 offerings when sales are only to accredited investors, along with comparable changes to Rule 144A (Title II);
- establish a small offering exemption for crowdfunding (Title III); and
- create a new exemption for offerings up to \$50 million (Title IV).

The JOBS Act also raises the holder-of-record threshold for mandatory registration under the Securities Exchange

Act of 1934, as amended (the Exchange Act) (Titles V and VI). In the chapters that follow, we discuss each of these measures in greater detail, but before we do so, it is important to understand the concerns that led legislators to act in concert to adopt the JOBS Act.

The lifecycle for emerging companies in the United States

For a long time in the United States, a company's financing lifecycle was generally fairly predictable. A growing company usually financed its business through investments from friends and family, then perhaps from angel investors, and finally, if the company was successful, from venture capital firms. Given the application of section 5 of the Securities Act of 1933, as amended (the Securities Act)¹ to public offerings of securities, a company was required to limit itself to conducting small rounds of financing, relying on various available exemptions from the registration requirements of the Securities Act, and to target principally sophisticated institutional investors. The securities that a company sold in these private or exempt offerings were classed as restricted securities, which means that the securities had never been offered pursuant to a registration statement and were subject to certain transfer restrictions. After various successful private financing rounds, the company's management and venture investors would begin to consider an IPO. Once a company was an SEC-reporting issuer, it became subject to a comprehensive regulatory framework. Although this regulatory framework may have imposed requirements that seemed onerous (at the time), being a public company offered distinct benefits. Once public, a company generally had many more financing opportunities. Already public companies relied on raising additional capital to finance their growth through follow-on public offerings, underwritten by one or more investment banks. From time to time, an already public company also might conduct a private placement or other exempt offering as part of an overall financing plan. Over time, as the capital markets in the United States have undergone changes and as regulations have evolved, the cost-benefit calculus for many companies has changed. Many companies have

concluded that going public might not be the most desirable liquidity event and remaining private longer or considering acquisition alternatives might be more appealing. A bit of background on the securities regulatory framework will help illustrate why the analysis changed for many companies.

Securities regulatory framework

A privately-held company (or a company that does not have securities that are publicly traded in the United States), whether domestic or foreign, that would like to access the US markets first must determine whether it is willing to subject itself to the ongoing securities reporting and disclosure requirements, as well as the corporate governance requirements that are part and parcel of registering securities publicly in the United States. An issuer may conduct a public offering in the United States by registering the offering and sale of its securities pursuant to the Securities Act, and also by registering its securities for listing or trading on a US securities exchange pursuant to the Exchange Act.² Instead, an issuer may choose to access the US capital markets by offering its securities in an offering exempt from the registration requirements of the Securities Act. Finally, a private company that elects to postpone, or seeks to avoid, becoming a public company may become subject to SEC reporting obligations inadvertently if it has: total assets exceeding \$10 million as of the last day of its fiscal year, and a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors (for banks and bank holding companies, a class of equity securities held of record by 2,000 or more persons), whether or not that class of equity securities is listed on a national securities exchange.

Section 5 of the Securities Act sets forth the registration and prospectus delivery requirements for securities offerings.³ In connection with any offer or sale of securities in interstate commerce or through the use of the mails, section 5 requires that a registration statement must be in effect and a prospectus meeting the prospectus requirements of section 10 of the Securities Act must be delivered before sale.⁴ This means that the Securities Act generally requires registration for any sale of securities, although it also provides exemptions or exclusions from this general registration requirement. The purpose of the Securities Act is to ensure that an issuer provides investors with all information material to an investment decision about the securities that it is offering. The registration and prospectus delivery requirements of section 5 require filings with the SEC and are intended to protect investors by providing them with sufficient information about the

issuer and its business and operations, as well as about the offering, so that they may make informed investment decisions. These apply to offerings that are made to the general public (regardless of the sophistication of the offerees). The SEC presumes that distributions not involving public offerings (or widespread distributions) do not involve the same public policy concerns as offerings made to a limited number of offerees that have access to the same kind of information that would be included in a registration statement. That information can be conveyed by providing disclosure or by ensuring that the offerees have access to the information. There are a number of regulatory restrictions on communications for issuers that undertake a public offering, given that the SEC always has emphasised that the prospectus should be the principal document used by investors in making their investment decision.

IPO and Exchange Act registration

In connection with an initial public offering of securities, an issuer must provide extensive information about its business and financial results. The preparation of the registration statement is time-consuming and expensive. Once the document is filed with the SEC, the SEC will review it closely and provide the issuer with detailed comments. The comment process may take as long as 60 to 90 days once a document has been filed with, or submitted to, the SEC. Once all of the comments have been addressed and the SEC staff is satisfied that the registration statement is properly responsive, the registration statement may be used in connection with the solicitation of offers to purchase the issuer's securities. Depending upon the nature of the issuer and the nature of the securities being offered by the issuer, the issuer may use one of various forms of registration statement. Once an issuer has determined to register its securities under the Securities Act, the issuer usually will also apply to have that class of its securities listed or quoted on a securities exchange, and in connection with doing so will register its securities under the Exchange Act. The Exchange Act imposes two separate but related obligations on issuers: registration obligations and reporting obligations. If an issuer becomes subject to the reporting requirements of the Exchange Act, the issuer remains subject to those requirements until, in the case of exchange-listed securities, those securities are delisted, or, in the case of securities listed by reason of the issuer's asset size and number of record holders, the issuer certifies that it meets certain requirements.

Once an issuer conducts an IPO in the United States or has a class of securities listed or traded on a national

securities exchange, the issuer will be generally subject to the reporting requirements of the Exchange Act. Issuers that have undertaken an IPO or that are SEC-reporting companies also will become subject to many other rules and regulations.

Over time, the regulatory burdens for public companies have increased. In 2002, following a series of widely reported corporate scandals involving fraudulent accounting practices and governance abuses, the United States adopted legislation affecting all public companies, the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley imposed a broad series of requirements relating to corporate governance, enhanced public disclosure, and the imposition of civil and criminal penalties for wrongdoing. Sarbanes-Oxley and its associated rules:

- require that CEOs and CFOs certify the accuracy and completeness of their company's periodic reports and impose criminal penalties for false certification;
- require the establishment and regular evaluation of disclosure controls and procedures, and internal control over financial reporting designed to ensure the accuracy and completeness of the information reported to the SEC and for the preparation of financial statements;
- require the establishment by all listed companies of an independent audit committee;
- require the disgorgement of compensation by CEOs and CFOs following an accounting misstatement that results from misconduct;
- impose limitations on trading by officers and directors during retirement plan blackout periods;
- prohibit the extension of credit to related parties; and
- require the SEC to review a registrant's filings once every three years.

Although relief from compliance with certain of these requirements was provided to smaller companies, increased compliance costs and increased liability may have had a chilling effect on IPOs.

To (or not to) go public

Many commentators have noted that, over time, the US capital markets have become less competitive, and the number of companies seeking to go public has declined. For example, in communications from Congressman Darrell Issa, chairman of the House Committee on Oversight and Government Reform, to Mary Schapiro, chairman of the SEC (discussed further below), Issa noted that the number of IPOs in the US has plummeted from an annual average of 530 during the 1990s to about 126 since 2001, with only 38 in 2008 and 61 in 2009.⁵ The number of companies listed on the main US exchanges peaked at more than 7,000 in 1997 and has been declining

ever since – it is now at about 4,000.⁶ Meanwhile, the value of transactions in private-company shares has grown, almost doubling in 2010 to \$4.6 billion from about \$2.4 billion in 2009, and was expected to increase to \$6.9 billion for 2011.⁷ Other reports cite similar statistics and highlight that smaller companies have been disproportionately affected, with most IPOs that are completed involving larger companies and a significant offering size. Although commentators would be ready to stipulate that the number of IPOs is down, there would be little agreement regarding the causes for the decline. Quite a number of different theories have been advanced to explain this phenomenon. Academics active in this area have grouped the theories into two broad categories: first, those attributing the decline to regulatory overreach, and second, those attributing the decline to changes in the ecosystem or market structure changes.

Many studies indicate that companies are waiting longer to go public as a result of anticipated costs associated with Sarbanes-Oxley compliance, as well as the additional costs associated with being a public company. For example, a public company must incur costs for D&O insurance, director compensation (especially audit committees), and disclosure controls and SEC reporting costs. Foreign issuers may be wary of the increased liability that comes with being an SEC-reporting company, as well as of the litigious environment in the United States. Many executive officers of privately-held companies also are concerned that going public will limit their flexibility. As officers of a public company, they are required to make very difficult decisions, including decisions regarding financial reporting, accounting estimates and accounting policies, while they are subject to more scrutiny and more risk as a result of their choices. Given the prospect of shareholder litigation and other litigation concerns, their determinations become fraught with risk. Earnings pressure and the need to respond to many constituencies (such as research analysts, large institutional holders and aggressive hedge fund holders) may affect the decision-making processes. This may inhibit their desire to take risk and may lead them to be more conservative than they otherwise would be. A recent survey found that, in fact, the principal reason given by senior managers of privately-held companies for remaining private is that they would like to preserve decision-making control.⁸ In addition, actually conducting an IPO will be time-consuming and expensive given the disclosure and financial statement requirements.

Over time, more financing alternatives have developed for issuers. An issuer could choose to avail itself of one of the exemptions from registration and conduct private

offerings. There have been many regulatory changes that have provided greater legal certainty as to the availability of private offering exemptions, such as the safe harbours contained in Regulation D, especially Rule 506. In large measure, as a result of these changes, a number of securities offering methodologies involving exempt offerings have developed and become increasingly popular. Many of these offering methodologies have come to resemble the process used for public distributions of securities. Investors have become more receptive to participating in private placements and owning so-called restricted securities as the limitations on hedging or transferring restricted securities have been relaxed. More recently, private secondary markets have developed that provide liquidity opportunities for holders of the securities of private companies to sell their positions.

Other commentators and academics note that a variety of market structure changes may be the cause of or may contribute to the decline of IPOs, and, especially smaller company IPOs. During the 1990s and early 2000s, consolidation in the investment banking sector led to the disappearance of many boutique or speciality investment banks that had as their focus financing transactions for smaller companies. Some commentators point to the drop in bid-ask spreads that took place following decimalisation in 2001. In 2003, as a result of the fallout from the dot-com boom, rules and regulations were adopted that imposed restrictions on research analyst coverage and required the separation of research and investment banking activities. The burdensome regulations imposed significant compliance costs on investment banks with research activities and changed the nature of research coverage. As a result, the fewer, larger investment banks that remained after industry consolidation focused their resources on covering fewer companies (usually giving preference to larger, well-capitalised companies). These various factors seemed to change the economics associated with smaller company IPOs and tend to favour IPOs by larger, more established companies. Also, the view developed that larger companies, with a longer track record and more predictable earnings histories, make better public companies or are better able to function as public companies.

SEC developments

The SEC has tried to keep pace with changes in the capital markets and has consistently introduced reforms that sought to balance investor protection needs with the need to provide issuers with access to capital. Since the early 1980s, the SEC has undertaken a number of steps to facilitate capital formation. The SEC has, among other

changes, created and modified the integrated disclosure system, instituted and expanded the continuous and delayed offerings processes, permitted the electronic submission of most SEC filings, and generally tried to accommodate the needs of both large and small issuers. In 2005, the SEC undertook a series of changes related to securities offerings and offering-related communications, referred to as securities offering reform. Although this reform benefited principally the largest and most sophisticated issuers (well-known seasoned issuers, or WKSIs), the changes also expanded the range of permissible communications, even during IPOs.

In December 2004, the SEC established the Advisory Committee on Smaller Public Companies to “assist the SEC in evaluating the current securities regulatory system relating to disclosure, financial reporting, internal controls, and offering exemptions for smaller public companies.”⁹ The Advisory Committee charter stated that its objective was “to assess the impact of the current regulatory system for smaller companies under the securities laws of the United States and to make recommendations for changes.”¹⁰ The Advisory Committee considered the effect of many new regulatory requirements on smaller public companies, as well as capital-raising alternatives for smaller companies. In 2006, it issued its final report, containing 33 recommendations, many of which focused on capital formation, including a recommendation that a new private offering exemption from the Securities Act registration requirements be adopted that would not prohibit general solicitation and advertising for transactions with purchasers that do not need all the protections of Securities Act registration requirements. The Advisory Committee noted that the ban on general solicitation in a private offering resulted in excessive concern about the offeree that may never actually purchase securities, rather than on protection of the actual investors. The Committee also noted that, given the pace of technological change, the bank had become outmoded and limited issuers from using the internet and other tools to communicate with potential investors. This was not the first time that a recommendation had been made to ease the prohibition on general solicitation. In 2007, practitioners that were members of an American Bar Association Committee submitted a letter to the SEC containing recommendations for a comprehensive overhaul of the securities laws governing the private placement of securities.¹¹ The letter cited problems with the private offering process that impacted capital formation. In May 2007, the SEC approved publication of eight releases designed to update and improve federal securities regulations that significantly affect smaller public

companies and their investors. Ultimately, the holding period requirements under Rules 144 and 145 were shortened, making restricted securities more liquid, and smaller public companies gained limited access to the use of shelf registration statements.

Although all of these reforms modernised the securities offering process, streamlined communications requirements, and addressed certain of the concerns related to private or exempt offerings, the reforms did not squarely address the IPO process, nor did they address many of the thorniest issues arising in exempt offerings.

Proposed changes post-Dodd-Frank

In the aftermath of the financial crisis, and following adoption of the Dodd-Frank Act, there was renewed focus on the effect of regulation on the competitiveness of the US capital markets and on entrepreneurship and emerging companies. As attention in the United States turned to promoting economic activity, the dialogue related to regulatory burdens and their effect on capital formation took on a new sense of urgency.

Issa-Schapiro correspondence

On March 22 2011, House Committee on Oversight and Government Reform chairman Issa sent a letter to SEC chairman Schapiro. The letter raised concerns about whether the current securities regulatory framework had a negative impact on capital formation, leading to the dearth of IPOs in the US, as well as the extent to which SEC regulations potentially limited other capital raising activities by small and emerging companies.¹² The letter from Issa also sought specific information regarding economic studies conducted by the SEC staff in these areas, along with information concerning the consideration of costs and benefits in connection with SEC rulemakings. Issa's letter discussed these statistics and raised questions about five topics: the decline of the US IPO market, the communications rules in connection with securities offerings, the 499-shareholder cap under section 12(g) of the Exchange Act, organisational considerations, and new capital-raising strategies.

In her response dated April 6 2011, Schapiro stated she had requested that the SEC staff take a fresh look at the agency's rules in order to develop ideas for the SEC about ways to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection.¹³ Schapiro outlined a number of new SEC initiatives in her response, including SEC staff review of (i) the restrictions on communications in initial public offerings; (ii) whether the general solicitation ban should be revisited; (iii) the number of shareholders that trigger

public reporting, including questions regarding the use of special purpose vehicles; and (iv) the regulatory questions posed by new capital-raising strategies, such as crowdfunding. Schapiro also indicated that the SEC was in the process of forming a new Advisory Committee on Small and Emerging Companies, which was subsequently convened.

Decline of the IPO market in the US

Issa's letter cited statistics about the declining US IPO market and asked whether the SEC had evaluated the reasons for such a decline. The letter asked whether the possible reasons for the decline included increasingly complex SEC regulations; costs associated with compliance with the Sarbanes-Oxley Act; the uncertainty generated by the pending rulemakings under the Dodd-Frank Wall Street Reform and Consumer Protection Act (generally known simply as the Dodd-Frank Act); the risk of class-action lawsuits; or the expansion of regulatory, legal, and compliance burdens. The letter also cited examples of the IPOs of Google and GoDaddy.com that were delayed and cancelled, respectively, as evidence of overly burdensome communications rules. In her response, Schapiro discussed various reasons for the decline in the IPO market, such as each company's own situation and market factors at the time of the contemplated IPO. Schapiro stated that it is difficult to determine why a company decides to undertake an IPO or declines to do so. The costs associated with conducting an IPO and becoming a public reporting company factor into the decision as to whether to conduct an IPO. Schapiro stated that the SEC had lowered these costs in recent years and that, in 2010, approximately 40% of first-time registrants were smaller reporting companies. Similarly, in 2010, nearly half of registered offerings conducted by first-time registrants were for offerings of less than \$10 million. In a discussion about the challenges faced by early-stage growth companies, Schapiro pointed out that such companies have greater difficulty raising capital because of the lack of disclosure on a regular basis, smaller and more variable cash flows, a smaller asset base, and a larger percentage of intangible assets.

Schapiro also stated that while there are studies that show that the number of US IPOs had declined,¹⁴ other studies conducted by SEC staff members indicate that for the period 1995–2007, the US market's share of global IPOs in terms of total dollar proceeds and average dollar proceeds was much higher than those of the United Kingdom and Hong Kong.¹⁵ The other reason for companies to favour an IPO in the European markets is that the underwriters' spread is significantly lower than in

the United States. For example, the gross spread in the US for an offering size between \$25 million and \$100 million is approximately 7%, while in Europe it would be approximately 4% for a similar offering.

The impact of the communications rules

In his letter, Issa indicated that the communication rules governing the offerings of securities potentially conflict with the promotion of disclosure and transparency and the First Amendment. He requested an explanation for the potential harm to a non-accredited investor that may realistically result from the receipt of an advertisement by an issuer of unregistered securities that is targeted at accredited investors or QIB. In her response, Schapiro described the communications rules that apply to registered and unregistered offerings. Under the Securities Act, for registered offerings, an issuer's ability to communicate varies depending on the three phases of the registration process called the pre-filing period, quiet period, and the post-effective period.¹⁶ During the pre-filing period before filing a registration statement, an issuer may not offer securities.¹⁷ During the quiet period (or waiting period), an issuer can make oral offers but cannot make written offers other than through a prospectus that complies with section 10 of the Securities Act.¹⁸ In the post-effective period, an issuer can sell and deliver securities as long as a final prospectus that complies with section 10(a) of the Securities Act accompanies or precedes the delivery of the securities.

Schapiro discussed the offering reforms adopted in 2005 that liberalised an issuer's ability to communicate during offerings.¹⁹ She also clarified that had these rules been effective when Google and Salesforce.com conducted their IPOs, the SEC would not have imposed a cooling-off period to address gun-jumping concerns. Schapiro's letter points out that with respect to offerings not registered under the Securities Act, issuers relying on section 4(a)(2) of the Securities Act or its safe harbour, Rule 506 of Regulation D, generally are not allowed to use a general solicitation or advertising to attract investors to their offering. In addition, the SEC adopted Rule 155, another safe harbour, that allows companies to abandon a public offering and instead raise money through a private offering. Schapiro recognised that some view the general solicitation ban as a significant burden on capital raising and may be unnecessary as offerees who might be located through general solicitation and who might not purchase the securities would not be harmed.²⁰ Others, however, support the solicitation ban on the grounds that it helps prevent securities fraud by making it more difficult for fraudsters to attract investors or unscrupulous issuers to

condition the market.²¹

The 499-shareholder cap

Issa raised concerns about the 499-shareholder cap under section 12(g) of the Exchange Act as being a fundamental roadblock to private equity capital formation. The letter went on to cite the case of the Facebook equity issuance in which the 499-person threshold would have been overcome by grouping multiple shareholders into single entities. He questioned whether the use of special purpose vehicles (SPVs) for the purposes of facilitating investments in private companies resulted in disjointed or illiquid markets and prevented price discovery.

In her letter, Schapiro stated that Rule 12(g) of the Exchange Act was enacted by Congress in 1964 and that the securities markets have changed significantly since then. The section requires a company to register its securities with the SEC within 120 days after the last day of its fiscal year if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding \$10 million. Schapiro pointed out that today, the vast majority of shares of public companies are held in nominee or so-called street name and, as a result, individual shareholders are not counted because the securities are not held of record by those individuals. Conversely, in private companies, shareholders generally hold their shares directly, or of record, and thus those companies may exceed the 499-shareholder limit under Rule 12(g), which would require them to commence reporting. Schapiro stated in her letter that the issue of how holders are counted and how many holders should trigger registration will need to be examined.

In his letter, Issa also raised concerns about Rule 12g5-1(b)(3) of the Exchange Act. That rule states that if an issuer knows that the form of holding securities of record is primarily used to circumvent section 12(g), the beneficial holders will be deemed the record owners. Noting that this rule has been invoked sparingly, Schapiro stated that this rule is not meant to create uncertainty for issuers but rather is intended to prevent issuers from circumventing the registration requirements.

Schapiro also noted that Congress has provided the SEC with broad authority, in sections 12(h) and 36 of the Exchange Act, to make exemptions with respect to the section 12(g) registration requirements and that section 12(g) of the Exchange Act also allows the SEC to define the terms "held of record" and "total assets." Therefore, the SEC has the requisite authority to revise the shareholder threshold if it concludes that doing so is not inconsistent with the public interest or protection of investors.

New capital-raising strategies

The letter from Issa raised questions regarding crowdfunding, singling out that approach as a possible new method of capital formation that has gained popularity. Schapiro stated that she understands crowdfunding to be a new method of capital formation whereby groups of people pool money, typically small individual contributions, to support an effort by others to accomplish a specific goal. Initially, such arrangements did not trigger securities law issues because there was no profit participation. Schapiro noted, however, that interest in offering an ownership interest in a developing business and an opportunity for a return on investment capital is growing. She provided an example of crowdfunding as described to the staff as an offering of up to a maximum of \$100,000 of equity securities of a company, with individual investments capped at \$100. She noted that proponents of this approach to capital formation seek a registration exemption, and the SEC has been exploring several approaches to address this.²² In considering whether to grant an exemption from registration for such arrangements, Schapiro stated that the SEC would consider, for example, its experience with Securities Act Rule 504, which was revised in 1999 due to concerns about fraud in the market. The widespread use of the internet for capital raising presents additional challenges in this area.

Legislative and other efforts

At more or less the same time that these exchanges were taking place, legislative efforts were moving forward that contemplated other changes to the capital formation process for smaller and emerging companies. Representative David Schweikert introduced the Small Company Capital Formation Act of 2011 in the US House of Representatives, which sought to amend the Regulation A offering threshold from \$5 million to \$50 million for public offerings by smaller companies.²³ The Small Company Formation Act was introduced after hearings on the topic of capital formation were held in December 2010, during which industry representatives expressed support for Regulation A reform as well as other changes to the capital formation process.

During the same session of Congress, other individual bills were introduced that would have increased the threshold for mandatory registration for all companies under the Exchange Act from 500 persons holding equity securities of record to 1,000 persons, and that would have amended section 12(g) of the Exchange Act by raising the registration threshold from 500 to 2,000 record holders if the issuer is a bank or a bank holding company.²⁴

Representative Patrick McHenry introduced legislation that would have added a crowdfunding exemption under both section 4 of the Securities Act and section 12(g) of the Exchange Act. Representative Kevin McCarthy introduced legislation to amend section 4(a)(2) of the Securities Act to state specifically that general solicitation and general advertising would not affect the availability of the private placement exemption to registration under section 5 of the Securities Act, and to direct the SEC to remove the prohibition against general solicitation and advertising for securities issued under Rule 506 of Regulation D, provided that all purchasers of the securities are accredited investors and that the issuer took reasonable steps set forth by the SEC to ascertain that the holder is indeed an accredited investor. Of course, these individual legislative proposals were the precursors to the JOBS Act.

In March 2011, the US Treasury Department convened the Access to Capital Conference to “gather insights from capital markets participants and solicit recommendations for how to restore access to capital for emerging companies – especially public capital through the IPO market.” At this conference, a small group of professionals representing broad sectors of the IPO market decided to form the IPO Task Force to examine the challenges that emerging growth companies face in pursuing IPOs, and to provide recommendations for restoring effective access to the public markets for emerging growth companies.

The Task Force published its report, titled *Rebuilding the IPO On-Ramp*, in October 2011.²⁵ In the report, the Task Force noted that after achieving a one-year high of 791 IPOs in 1996, the US IPO market severely declined from 2001 to 2008, averaging only 157 IPOs per year during that period, with a low of 45 in 2008, with IPOs by smaller companies showing the steepest declines. The report presents a nuanced view of the causes of this decline, pointing to a series of regulatory and market structure changes. The report notes that these changes have coalesced and as a result have had the effect of driving up costs for smaller companies looking to go public; constraining the amount of information available to investors about such companies; and shifting the economics of investment banking away from long-term investing in such companies and toward high-frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, smaller companies. The report made four principal recommendations to the Treasury Department: providing an on-ramp (or phasing in of disclosure requirements) for smaller companies that complete IPOs; improving the availability and flow of information for investors before and after an IPO; lowering the capital gains tax rate for investors who

purchase shares in an IPO and hold these shares for a minimum of two years; and educating issuers about how to succeed in the new capital markets environment. The Task Force stressed that these recommendations purport only to adjust the scale of current regulations, not change the focus on investor protection.

In December 2011, legislation, titled the Reopening American Capital Markets to Emerging Growth Companies Act of 2011, was introduced that incorporated many of the recommendations included in the Report, including a proposal to amend section 2(a) of the Securities Act and section 3(a) of the Exchange Act by creating a new category of issuer called an “emerging growth company” and exempting these emerging growth companies, at least initially, from certain requirements. This legislation formed the basis of much of Title I of the JOBS Act.

The legislative efforts received a boost when, in January 2012, President Obama expressed support for a number of these initiatives. During his State of the Union address, the President emphasised the need to foster innovation and encourage start-ups and small businesses. On January 31 2012, the President released the Startup America Legislative Agenda to Congress, which reflected support for an increase in the offering threshold in Regulation A, a “national framework” for crowdfunding, and the adoption of an IPO on-ramp. Shortly thereafter, the individual legislative initiatives referenced above coalesced into a single legislative proposal, and so we finish where we started off, with the enactment of the JOBS Act. In the chapters that follow, we provide a summary of the main provisions of the JOBS Act and a discussion of their effect on capital formation.

ENDNOTES

1. Securities Act of 1933, 48 Stat. 74 (May 27 1933), codified at 15 USC § 77a *et seq.* (as amended, the Securities Act).
2. Securities Exchange Act of 1934, 48 Stat. 881 (June 6 1934), codified at 15 USC § 78a *et seq.* (as amended, the Exchange Act).
3. 15 USC § 77e.
4. 15 USC § 77e(b).
5. *See* <http://www.gt.com/staticfiles//GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf>.
6. *See id.*
7. *See* <http://online.wsj.com/article/SB10001424052748704630004576249182275134552.html?KEYWORDS=%22new+stock+rules%22>.
8. *See* James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. Fin. 399 (2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530924.
9. Securities Act Release No. 33-8514, 87 S.E.C. Docket 1138 (February 28 2006); Exchange Act Release No. 34-50864, 84 S.E.C. Docket 1340 (December 16 2004).
10. Advisory Committee on Smaller Public Companies, Charter, *available at* <http://sec.gov/info/smallbus/acspc.shtml>.
11. Letter from Keith F. Higgins, Chair, ABA Committee on Federal Regulation of Securities, to John W. White, Director, Division of Corporation Finance (March 22 2007), *available at* www.abanet.org/buslaw/committees/CL410000pub/comments/20070322000000.pdf.
12. *See* <http://www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf>.
13. *See* <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>.
14. *See, e.g.* D. Weild and E. Kim, *A Wake Up Call for America*, Grant Thornton LLP (2009); Committee on Capital Markets Regulation, *Continued Erosion in Competitiveness of the U.S. Equity Markets* (2009).
15. *See* C. Caglio, K. Weiss Hanley and Marietta-Westberg, *Going Public Abroad: The Role of International Markets for IPOs* (February 2011).
16. The Securities Act does not state when the pre-filing period begins. The SEC has stated that an issuer will be in registration at least from the time it begins preparing the related registration statement or the time it has reached an understanding with an underwriter, even if all the terms or conditions of the underwriting arrangement have not been agreed upon. *See* SEC Release No. 33-5009, *Publication of Information Before or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933* (October 7 1969); SEC Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (August 16 1971).
17. *See* Securities Act § 5(c).
18. *See* Securities Act § 5(b)(1).
19. *See* Release No. 33-8591, *Securities Offering Reform* (July 19 2005), <http://www.sec.gov/rules/final/33-8591.pdf>.
20. *See, e.g.*, Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April 23 2006), *available at* <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>; Joseph McLaughlin, *How the SEC Stifles Investment – and Speech*, *The Wall Street Journal* (February 3 2011). Concerns about the scope of the Commission’s rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. *See* 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), *available at* <http://www.sec.gov/info/smallbus/gbfor28.pdf>.
21. *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) (“The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.”).
22. For example, crowdfunding was discussed at the SEC’s November 2010 Forum on Small Business Capital Formation. Participants in the Forum recommended that the SEC consider implementing a new exemption from Securities Act registration for crowdfunding, which would include offerings of up

to \$100,000 and a cap on individual investments not to exceed \$100. In January 2011, representatives from the Division of Corporation Finance's Office of Small Business Policy met with a group from the Small Business & Entrepreneurship Council, which advocated an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, the Office of Small Business Policy and other members of the Division of Corporation Finance Staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organisation of state securities regulators, at a conference held on March 28 2011.

23. HR 1070, *available at*
<http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070ih/pdf/BILLS-112hr1070ih.pdf>.
24. Note that this change merely puts into the statute the current requirements of SEC rules under Sections 12(g) and 15(d) of the Securities Act.
25. *See*
http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

CHAPTER 1

The IPO on-ramp

Title I of the JOBS Act establishes a new process and disclosure regime for IPOs by a new class of companies referred to as emerging growth companies (EGCs). As discussed in the Introduction, Title I of the JOBS Act was enacted based on the recommendations of the Task Force, which sought ways to improve the offering process as a means for encouraging more IPOs in the United States. As truly the centrepiece of the JOBS Act, Title I contemplates, for those companies that qualify as EGCs, confidential SEC staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on test-the-waters communications with qualified institutional buyers (QIBs) and institutional accredited investors before and after filing a registration statement, and fewer restrictions on research (including research by participating underwriters) around the time of an offering. Because Title I was retroactively effective to December 9 2011 for issuers that qualified as EGCs, it has had the most significant impact to date on the regulation of capital formation transactions.

Given the immediate effectiveness of Title I of the JOBS Act, the SEC staff provided interpretive guidance in the form of frequently asked questions that are posted on the SEC's website. The FAQs were initially issued on April 16 2012 and were updated on May 3 2012 and September 28 2012.¹ These FAQs are not rules or regulations of the SEC, but rather reflect the views of the staff of the SEC's Division of Corporation Finance.

The definition of EGC

In order to qualify for the IPO on-ramp contemplated by Title I of the JOBS Act, an issuer must qualify as an EGC, which is determined for the purpose of the reporting, accounting, auditing and corporate governance breaks that the company may use if it went public through a registered securities offering on or after December 9 2011, and for an IPO at any time during the process when the EGC is making use of the Title I provisions.

The \$1 billion in revenue test

An EGC is defined for the purposes of Title I as an issuer (including a foreign private issuer) with total annual gross

revenues of less than \$1 billion (subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year.² The SEC indicates that the phrase "total annual gross revenues" means total revenues of the issuer (or a predecessor of the issuer, if the predecessor's financial statements are presented in the registration statement for the most recent fiscal year), as presented on the income statement in accordance with US generally accepted accounting principles (GAAP).³ If a foreign private issuer is using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) as its basis for presentation, then the IFRS revenue number is used for this test.⁴ Because an issuer must determine its EGC status based on revenues as expressed in US dollars, the SEC staff indicates that a foreign private issuer's conversion of revenues should be based on the exchange rate as of the last day of the fiscal year.⁵ For financial institutions, the SEC has indicated that total annual gross revenues should be determined in the manner consistent with the approach used for determining status as a "smaller reporting company," which looks to all gross revenues from traditional banking activities. For this purpose, a financial institution must include all gross revenues from traditional banking activities. Banking activity revenues include interest on loans and investments, dividends on investments, fees from loan origination, fees from trust and investment services, commissions, brokerage fees, mortgage servicing revenues, and any other fees or income from banking or related services. Revenues do not include gains and losses on dispositions of investment portfolio securities (although it may include gains on trading account activity if that is a regular part of the institution's activities).⁶

By way of example, the SEC indicates that, in applying the revenue test for determining EGC status, a calendar year-end issuer that would like to file a registration statement for an initial public offering of common equity securities in January 2013 (which would present financial statements for 2011 and 2010 and the nine months ended September 30 2012 and 2011) should look to its most recently completed fiscal year, which would be the most

recent annual period completed, regardless of whether financial statements for the period are presented in the registration statement. In this example, the most recent annual period completed would be 2012.⁷

Applicability of the December 9 2011 effective date

An issuer can qualify as an EGC if it first sold its common stock in a registered offering on or after December 9 2011. The SEC has indicated that this eligibility determination is not limited to initial public offerings that took place on or before December 8 2011, in that it could also include an offering of common equity securities under an employee benefit plan on Form S-8, as well as a selling shareholder's registered secondary offering.⁸ The SEC notes that just having a registration statement go effective on or before December 8 2011 is not a bar to EGC status, as long as no common equity securities were actually sold off of the registration statement on or before December 8 2011.⁹

Qualification for EGC status

The SEC has indicated that asset-backed issuers and registered investment companies do not qualify as EGCs; however, business development companies could qualify.¹⁰ The SEC may determine, through the course of its review process or otherwise, that other particular types of issuers are not EGCs for the purposes of Title I of the JOBS Act.

Previously public issuers

An issuer that succeeds to a predecessor's Exchange Act registration or reporting obligations under Rules 12g-3 and 15d-5 will not qualify for EGC status if the predecessor's first sale of common equity securities occurred on or before December 8 2011, as the predecessor was not eligible for that EGC status.¹¹

The SEC has addressed the EGC status of an issuer that was once an Exchange Act reporting company but is not required to file Exchange Act reports.¹² The SEC notes that such an issuer can take advantage of the benefits of EGC status, even though its initial public offering of common equity securities occurred on or before December 8 2011. In this regard, the SEC indicates that if an issuer would otherwise qualify as an EGC but for the fact that its initial public offering of common equity securities occurred on or before December 8 2011, and such issuer was once an Exchange Act reporting company but is not required to file Exchange Act reports, then the SEC would not object if such issuer takes advantage of all of the benefits of EGC status for its next registered offering and thereafter, until it triggers one of the disqualification provisions in sections 2(a)(19)(A)-(D) of the Securities Act. This position is not available to an issuer that has had the registration of a class

of its securities revoked pursuant to Exchange Act section 12(j). The SEC goes on to note that, based on the particular facts and circumstances, the EGC status of an issuer may be questioned if it appears that the issuer ceased to be a reporting company for the purpose of conducting a registered offering as an EGC. The SEC recommends that issuers with questions relating to these issues should contact the Division of Corporation Finance's Office of the Chief Counsel.

This interpretation seeks to address EGC status for those companies that were taken private through private equity or management buyouts with the expectation of a liquidity event or exit through an IPO in the future, which have made up a relatively significant portion of the IPO market in recent years.

Losing EGC status

Status as an EGC is maintained until the earliest of:

- the last day of the fiscal year in which the issuer's total annual gross revenues are \$1 billion or more;
- the last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act (for an debt-only issuer that never sold its common equity pursuant to an Exchange Act registration statement, this five-year period will not run);
- any date on which the issuer has, during the prior three-year period, issued more than \$1 billion in non-convertible debt; or
- the date on which the issuer becomes a "Large Accelerated Filer," as defined in the SEC's rules.¹³

With regard to the \$1 billion debt issuance test, the SEC has indicated that the three-year period covers any rolling three-year period, which is not in any way limited to completed calendar or fiscal years.¹⁴ The SEC also noted that it reads "non-convertible debt" to mean any non-convertible security that constitutes indebtedness (whether issued in a registered offering or not), thereby excluding bank debt or credit facilities.¹⁵ The debt test references debt issued, as opposed to issued and outstanding, so that any debt issued to refinance existing indebtedness over the course of the three-year period could be counted multiple times. The SEC has indicated, however, that the staff will not object if an issuer does not double count the principal amount from a private placement and the principal amount from the related Exxon Capital or A/B exchange offer.¹⁶

The SEC also addressed two specific examples and how the EGC status of the issuer would be determined in the event of an acquisition or reverse merger.¹⁷

	Example 1: Forward acquisition	Example 2: Reverse merger
\$1B annual revenues test	In 2012, look to Company A's revenues for 2011. In 2013, look to Company A's revenues for 2012, which will include Company B's revenues from October 1 2012.	In 2012, look to Company D's revenues for 2011. In 2013, look to Company D's revenues for 2012, which will include Company C's revenues from October 1 2012.
Five-year anniversary test	Look to Company A's date of first sale.	Look to Company C's date of first sale.
\$1B issued debt during previous three years test	Look to Company A's debt issuances, which will include Company B's debt issuances from October 1 2012.	Look to Company D's debt issuances, which will include Company C's debt issuances from October 1 2012.
Large accelerated filer test	At December 31 2012, look to Company A's market value at June 30 2012. At December 31 2013, look to Company A's market value (which will include Company B's) at June 30 2013.	At December 31 2012, look to Company C's market value at June 30 2012. At December 31 2013, look to Company C's market value (which will include Company D's) at June 30 2013.

- In Example 1, Company A acquires Company B for cash or stock, in a forward acquisition. Company A is both the legal acquirer and the accounting acquirer.
- In Example 2, Company C undertakes a reverse merger with Company D, an operating company. Company D is presented as the predecessor in the post-transaction financial statements.

In each example, the companies' fiscal year is the calendar year; the transactions occur on September 30 2012; and FAQ 24, which relates to succession of Exchange Act obligations, is not implicated. In determining whether Company A and Company C trigger any of the disqualifications from the definition of EGC in section 2(a)(19)(A), (B), (C) or (D) (referenced above), the SEC staff notes the following framework:

Timing of the EGC determination

Securities Act Rule 401(a) provides that "the form and contents of a registration statement and prospectus shall conform to the applicable rules and forms as in effect on the initial filing date of such registration statement and prospectus," and applies to registration statements at the initial filing date, not at the time that a registration statement is submitted for confidential review.¹⁸ Therefore, an issuer must qualify as an EGC at the time of submission in order to use the confidential review process for a registration statement, or any amended submission of the

registration statement. If an issuer loses EGC status while the SEC staff is reviewing the registration statement on a confidential basis, then the issuer must file the registration statement and all of the draft submissions in order to proceed with the review process. When the EGC files the registration statement, the issuer's EGC status is retained while that registration statement is in registration by operation of Securities Act Rule 401(a). With regard to the use of the permitted test-the-waters communications under Securities Act section 5(d) (discussed below), an issuer must determine whether it qualifies as an EGC at the time it engages in the test-the-waters communications. In this regard, the SEC has noted that if the issuer later loses its EGC status by the time the registration statement is filed, then the issuer would not retroactively lose the ability to utilize prior test-the-waters communications.¹⁹

Benefits available to EGCs

When an issuer qualifies as an EGC, it may take advantage of a number of benefits in connection with its IPO and subsequent public reporting and corporate governance. These benefits are designed to facilitate the public offering process, promote communications in and around the time of the IPO, and allow the EGC to ease into certain public reporting, accounting, auditing, and corporate governance requirements.

EGC communications

Title I of the JOBS Act provides EGCs, or any other person they authorise, the flexibility to engage in oral or written communications with QIBs and institutional accredited investors in order to gauge their interest in a proposed offering, whether before or following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a Securities Act section 10(a) prospectus.²⁰ This provision allows an EGC to test the waters for a potential IPO by communicating with investors and gauging their potential interest in the offering.²¹ An EGC can use the test-the-waters provision with respect to any registered offerings that it conducts while qualifying for EGC status. There are no form or content restrictions on these communications, and there is no requirement to file written communications with the SEC. In the course of reviewing the registration statements of an EGC, the SEC staff has requested the EGCs submit any written test-the-waters materials to the SEC, so that the SEC staff can determine whether those materials would provide any guidance as to information that should be included in the prospectus.

The SEC has addressed the interplay of these test-the-waters communications, and the requirements of Exchange Act Rule 15c2-8(e).²² Rule 15c2-8(e) requires that a broker-dealer make available a copy of the preliminary prospectus (before the effective date) for a registered offering of securities before soliciting orders from customers. If read broadly, the prohibitions of Rule 15c2-8(e) might constrain the types of activities that are permissible during test-the-waters discussions. The FAQs note that while the JOBS Act does not amend Rule 15c2-8(e) (that is, the JOBS Act does not modify the meaning of the term “solicit”), an EGC or a financial intermediary acting on the EGC’s behalf may engage in discussions with institutional investors to gauge their interest in purchasing EGC securities before the EGC has filed its registration statement with the SEC and after the EGC has filed its registration statement. During this period, the underwriter may discuss price, volume and market demand and solicit non-binding indications of interest from customers. Soliciting such a non-binding indication of interest, in the absence of other factors, would not constitute a solicitation for purposes of Rule 15c2-8(e).

The JOBS Act also permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an offering under the Securities Act or has a registration statement pending, and the research report will not be deemed an offer under the Securities Act, even if the broker-dealer will participate or is participating in

the offering. Further, no SRO or the SEC may adopt or maintain any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public appearance with respect to the securities of an EGC following an offering or in a period before expiration of a lock-up.²³ These provisions are discussed in greater detail in Chapter 8.

Confidential review process for EGC IPO registration statements

Title I provides that the SEC’s staff must review all EGC initial public offering registration statements confidentially.²⁴ An EGC may confidentially submit a draft registration statement for an initial public offering for non-public review, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the issuer’s commencement of a road show.²⁵ The SEC requires that confidential draft registration statements and amendments be submitted through the SEC’s electronic filing system (known as EDGAR) using submission form types DRS and DRS/A, respectively. No filing fee is due at the time of submitting the draft registration statement.²⁶

A confidential submission of a draft registration statement is not required to be signed by the registrant or by any of its officers or directors, nor is it required to include the consent of auditors and other experts, as it is not filed with the SEC.²⁷ While Securities Act section 6(e)(1) requires that the initial confidential submission and all amendments thereto be publicly filed with the SEC not later than 21 days before the date on which the issuer commences a road show, the SEC notes that upon public filing, the previous confidential submissions are not required to be signed and do not require consents.²⁸

The SEC expects that any registration statement submitted for confidential review will be substantially complete at the time of initial submission, including a signed audit report, and the required exhibits (however, the registration statement itself is not required to be signed or to include the consent of auditors and other experts). The SEC will defer review any draft registration statement that is materially deficient.²⁹

The confidential submission of a draft registration does not constitute the filing of a registration statement for the purposes of the prohibition in Securities Act section 5(c) against making offers of a security in advance of filing a registration statement.³⁰

Test-the-waters communications and the 21-day filing requirement

Securities Act section 6(e) provides that confidential registration statement submissions must be publicly filed with the SEC at least 21 days before the issuer conducts a road show. The term “road show” is defined as “an offer ... that contains a presentation regarding an offering by one or more members of the issuer’s management ... and includes discussion of one or more of the issuer, such management, and the securities being offered.”³¹ Given the breadth of this definition, the SEC has addressed the issue of whether the test-the-waters communications under Securities Act section 5(d) that are discussed above could be considered a road show for the purposes of triggering the 21-day filing requirement.³²

The SEC has noted that in a traditional underwritten public offering where test-the-waters communications are not used, the road show could be easily identified as “those meetings traditionally viewed as the road show when the emerging growth company and underwriters begin actively marketing the offering.” Under these circumstances, the EGC would be able to estimate when it expects to begin that road show, and then publicly file the registration statement and all of the confidential submissions at least 21 days before that date. Because Securities Act section 5(d) specifically contemplates test-the-waters communications taking place before filing a registration statement, and in the interest of reading the provisions in a consistent fashion, the SEC will not object if an EGC does not treat test-the-waters communications conducted in reliance on Securities Act section 5(d) as a road show for purposes of Securities Act section 6(e). The SEC notes, however, that if an issuer were to have meetings or other communications that meet the definition of a road show and which do not fall within the test-the-waters communications contemplated by section 5(d), then the 21-day filing requirement would be triggered based on the timing of such meetings. If an EGC does not conduct a traditional road show and does not engage in activities that would come within the definition of a road show, other than test-the-waters communications that comply with Securities Act section 5(d), the SEC Staff indicates that the issuer’s registration statement and confidential submissions should be filed publicly no later than 21 days before the anticipated date of effectiveness of the registration statement.³³

Registration statement disclosure for EGCs

The SEC has indicated that an EGC must identify itself as an EGC on the cover page of the prospectus.³⁴ In addition, SEC staff comments on EGC registration statements have requested the following disclosures:

- a description of how and when a company may lose EGC status;
- a brief description of the various exemptions that are available to an EGC, such as exemptions from Sarbanes-Oxley section 404(b) and the Say-on-Pay/Say-on-Golden Parachute provisions; and
- the EGC’s election under section 107(b) of the JOBS Act for extended transition to new or revised accounting standards.

The SEC staff requests that if the EGC has elected to opt out of the extended transition period for new or revised accounting standards, then it must include a statement that the election is irrevocable. If the EGC has elected to use the extended transition period, then risk factor disclosure must explain that this election allows an EGC to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. The SEC staff also requests that the EGC state in the risk factors that, as a result of this election, the EGC’s financial statements may not be comparable to issuers that comply with public issuer effective dates. A similar statement is also requested in the EGC’s critical accounting policy disclosures in MD&A.

An EGC is required to present only two years of audited financial statements in its initial public offering registration statement.³⁵ An EGC may also limit its MD&A to only cover those audited periods presented in the audited financial statements. The SEC has indicated that, notwithstanding Securities Act section 7(a)(2)(A)’s reference to “any other” registration statement, the SEC staff will not object if an EGC presenting two years of audited financial statements limits the selected financial data included in its initial public offering registration statement to only two years.³⁶ For financial statements required under Rules 3-05 and 3-09 of Regulation S-X under the Securities Act (Regulation S-X), the SEC staff will not object if only two years of financial statements are provided in the registration statement, even if the significance tests result in a requirement to present three years of financial statements for entities other than the issuer.³⁷ The SEC staff has further noted that it will not object if an issuer presents the ratio of earnings to fixed charges required by Item 503(d) of Regulation S-K under the Securities Act (Regulation S-K) for the same number of years for which it provides selected financial data.³⁸

An EGC may comply with the executive compensation disclosures applicable to a “smaller reporting company” as defined in the SEC’s rules, which means that an EGC need provide only a Summary Compensation Table (with three rather than five named executive officers and limited to two fiscal years of information), an Outstanding Equity Awards Table, and a Director Compensation Table, along with some narrative disclosures to augment those tables. EGCs are not required to provide a Compensation Discussion and Analysis, or disclosures about payments upon termination of employment or change in control.³⁹

Disclosure, corporate governance, accounting and auditing relief

Title I of the JOBS Act provides relief from a number of requirements for EGCs following an initial public offering. An EGC will not be subject to the Say-on-Pay, Say-on-Frequency or Say-on-Golden Parachute vote required by the Dodd-Frank Act and the SEC rules, for as long as the issuer qualifies as an EGC.⁴⁰ An issuer that was an EGC, but lost that status, will be required to comply with the Say-on-Pay vote requirement as follows: in the case of an issuer that was an EGC for less than two years, by the end of the three-year period following its IPO; and for any other issuer, within one year of having lost its EGC status.⁴¹ An EGC also is not subject to any requirement to disclose the relationship between executive compensation and the financial performance of the company, or any requirement to disclose the CEO’s pay relative to the median employee’s pay (should either such requirements ever be proposed and adopted by the SEC pursuant to the Dodd-Frank Act).⁴²

Under section 107(b) of the JOBS Act, an EGC will not be required to adopt any update to FASB’s Accounting Standards codification after April 5 2012 that has different effective dates for public companies and private companies that are not “issuers” under section 2(a) of Sarbanes-Oxley, until those standards apply to private companies. Under this provision, EGCs are able to take advantage of the extended transition period contemplated in those limited situations where there is a different effective date specified for private companies. If a new or revised accounting standard does not apply at all to private companies, then no transition would be permitted for EGCs, or if an accounting standard applies to both public and private companies, but provides for the same effective date for both types of companies, then no transition would be permitted for EGCs. Section 107(b)(1) of the JOBS Act provides that an EGC “must make such choice at the time the company is first required to file a registration statement, periodic report, or other report with the Commission” and to notify the SEC of such choice. The

SEC has noted that EGCs should notify the SEC staff of the issuer’s choice at the time of the initial confidential submission, and if an EGC is already in registration or subject to Exchange Act reporting, then the statement must appear in its next amendment to the registration statement or in its next periodic report.⁴³ Section 107(b)(2) provides that any decision to opt-out of the extended transition period for complying with new or revised accounting standards is irrevocable; however the SEC allows an EGC that opted into the extended transition period provision to subsequently opt out, as long as it complies with the applicable provisions of the JOBS Act and discloses its opting-out in the first periodic report or registration statement following the decision to do so.

An EGC is not subject to any potential rules or standards requiring mandatory audit firm rotation or a supplement to the auditor’s report that would provide additional information regarding the audit of the company’s financial statements (auditor discussion and analysis), should such requirements ever be proposed or adopted by the Public Company Accounting Oversight Board (PCAOB). Any other new auditing standards adopted by the PCAOB will not apply to EGC audits unless the SEC determines that such requirement is necessary and appropriate for investor protection.⁴⁴

An EGC is not subject to the requirement for an auditor attestation of internal controls pursuant to section 404(b) of Sarbanes-Oxley. The EGC is subject to the requirement that management establish, maintain, and assess internal control over financial reporting, once that is phased-in for a issuer conducting an initial public offering after the first year.⁴⁵

Other than the provisions for extended transition to new or revised accounting standards discussed above, an EGC may decide to follow only some of the scaled disclosure provisions and corporate governance breaks available for EGCs.⁴⁶

The SEC will not object if a foreign private issuer that qualifies as an EGC complies with the scaled disclosure provisions available to emerging growth companies to the extent relevant to the form requirements for foreign private issuers.⁴⁷

Required studies

The JOBS Act requires that the SEC conduct a number of studies. Under Title I, within 90 days of enactment of the Act, the SEC was required to present to Congress the findings of a study that examines the impact of decimatisation on initial public offerings and the impact of this change on liquidity for small- and mid-cap securities. If the SEC determined that securities of emerging growth

companies should be quoted or traded using a minimum increment higher than \$0.01, the SEC may, by rule, not later than 180 days following enactment of the Act, designate a higher minimum increment between \$0.01 and \$0.10.⁴⁸ Also under Title I, within 180 days of enactment, the SEC was required to present to Congress its findings and recommendations following a review of Regulation S-K that is intended to analyse current registration requirements and determine whether these requirements can be updated, modified or simplified in order to reduce costs and other burdens on emerging growth companies.⁴⁹

Decimalisation

On July 20 2012, the SEC delivered to Congress the report required by section 106 of the JOBS Act.⁵⁰ The study notes the observations of the IPO Task Force regarding the changing market structure and economics arising from the shift to decimal stock quotes, which point toward a negative impact on the economic sustainability of sell-side research and the greater emphasis placed on liquid, very large capitalisation stocks at the expense of smaller capitalisation stocks. The SEC's study takes a three-pronged approach to examining the issues: (i) reviewing empirical studies regarding tick size and decimalisation; (ii) participation in, and review of materials prepared in connection with, discussions concerning the impact of market structure on small and middle capitalisation companies and on IPOs as part of the SEC Advisory Committee on Small and Emerging Companies; and (iii) a survey of tick-size conventions in foreign markets.

The SEC concluded that decimalisation may have been one of a number of factors that have influenced the IPO market, and that the existing literature did not isolate the effect of decimalisation from the many other factors. The SEC also noted that markets have evolved significantly since decimalisation was implemented over a decade ago, and that other countries have used multiple tick sizes rather than the one-size-fits-all approach implemented in the United States. Based on the observations reported in the study, the SEC recommends that the Commission should not proceed with specific rulemaking to increase tick sizes, but should rather consider additional steps that may be needed to determine whether rulemaking should be undertaken, which might include soliciting the views of investors, companies, market professionals, academics and others on the broad topic of decimalisation and the impact on IPOs and the markets. In particular, the study notes the possibility of a roundtable where these issues can be addressed. The SEC announced that its staff will host a

roundtable in early 2013 to discuss the impact of decimal-based stock trading on small and mid-sized companies, market professionals, investors, and US securities markets.

Regulation S-K

On December 23 2013, the SEC delivered to Congress the report required by section 108 of the JOBS Act.⁵¹ The SEC was mandated to review Regulation S-K in the context of the new class of issuers referred to in the JOBS Act as EGCs. In connection with this review, the SEC staff chose to consider the background of the development of disclosure requirements and potential recommendations for revisiting disclosure requirements in a broad manner. The SEC staff reviewed, among other things, Regulation S-K, SEC releases and comment letters on SEC regulatory actions pertaining to Regulation S-K. The SEC staff also reviewed public comments that were submitted regarding section 108 of the JOBS Act. In light of the focus of the mandate in section 108 of the JOBS Act, the SEC staff did not review two subparts of Regulation S-K – Regulation AB and Regulation M-A.

The SEC staff noted that while the study conducted in connection with the section 108 report serves as an important starting point, further information gathering and review is warranted in order to formulate specific recommendations regarding specific disclosure requirements. The SEC staff stated that “input from market participants is needed to facilitate the identification of ways to update or add requirements for disclosure that is material to an investment or voting decision, ways to streamline and simplify disclosure requirements to reduce the costs and burdens on public companies, including emerging growth companies, ways to enhance the presentation and communication of information and to understand how technology can play a role in addressing any of these issues.” In addition, the SEC staff noted in the report that economic analysis is necessary to inform any reevaluation of disclosure requirements.

The SEC staff recommended the development of a plan to review systematically the SEC's disclosure requirements for public companies, including Regulations S-K and S-X, and the related rules concerning the presentation and delivery of information. Among the factors that will be considered in the review are disclosure requirements developed through SEC interpretations, as well external factors that may have contributed to the length and complexity of filings and the costs of compliance (eg SEC enforcement actions and judicial opinions). After conducting this detailed review, the SEC staff would make specific recommendations for proposed rule and form changes.

The SEC staff has identified two alternative frameworks for structuring such a review: a comprehensive approach and a targeted approach. The SEC staff believes that any such review could be more effective if it were to:

- Emphasise a principles-based approach as a critical aspect of the disclosure framework.
- Evaluate the appropriateness of current scaled disclosure requirements and whether further scaling would be appropriate for EGCs or other categories of issuers.
- Evaluate methods of information delivery and presentation, both through the EDGAR system and other means.
- Consider ways to present information that would improve the readability and navigability of disclosure documents, as well as discouragement of repetition and the disclosure of immaterial information.

In various public remarks, the Chair of the SEC has reiterated that the SEC intends to conduct a review of the disclosure requirements for public companies.⁵²

Appendix A DISCLOSURE AND RELATED REQUIREMENTS		
	Before JOBS Act	Under JOBS Act
Financial information in SEC filings	<ul style="list-style-type: none"> • Three years of audited financial statements • Two years of audited financial statements for smaller reporting companies • Selected financial data for each of five years (or for life of issuer, if shorter) and any interim period included in the financial statements 	<ul style="list-style-type: none"> • Two years of audited financial statements • Not required to present selected financial data for any period before the earliest audited period presented in connection with an IPO • Within one year of IPO, EGC would report three years of audited financial statements
Confidential submissions of draft IPO registration statement	<ul style="list-style-type: none"> • No confidential filing for US issuers • Confidential filing for FPIs only in specified circumstances 	EGCs (including FPIs that are EGCs) may submit a draft IPO registration statement for confidential review before public filing, provided that such submission and any amendments are publicly filed with the SEC not later than 21 days before the EGC conducts a road show, superseding the SEC's December 2011 position on confidential submissions by FPIs.
Communications before and during offering process	Limited ability to test the waters	EGCs, either before or after filing a registration statement, may test the waters by engaging in oral or written communications with QIBs and institutional accredited investors to determine interest in an offering
Auditor attestation on internal controls	<ul style="list-style-type: none"> • Auditor attestation on effectiveness of internal controls over financial reporting required in second annual report after IPO • Non-accelerated filers not required to comply 	Transition period for compliance of up to five years
Accounting standards	Must comply with applicable new or revised financial accounting standards	<ul style="list-style-type: none"> • Not required to comply with any new or revised financial accounting standard until such standard applies to companies that are not subject to Exchange Act public company reporting • EGCs may choose to comply with non-EGC accounting standards but may not selectively comply
Executive compensation disclosure	<ul style="list-style-type: none"> • Must comply with executive compensation disclosure requirements, unless a smaller reporting company (which is subject to reduced disclosure requirements) • Upon adoption of SEC rules under Dodd-Frank will be required to calculate and disclose the median compensation of all employees compared to the CEO 	<ul style="list-style-type: none"> • May comply with executive compensation disclosure requirements by complying with the reduced disclosure requirements generally available to smaller reporting companies • Exempt from requirement to calculate and disclose the median compensation of all employees compared to the CEO • FPIs entitled to rely on other executive compensation disclosure requirements
Say on pay	<ul style="list-style-type: none"> • Must hold non-binding advisory stockholder votes on executive compensation arrangements • Smaller reporting companies are exempt from say on pay until 2013 	Exempt from requirement to hold non-binding advisory stockholder votes on executive compensation arrangements for one to three years after no longer an EGC

ENDNOTES

1. Frequently Asked Questions of General Applicability on Title I of the JOBS Act (April 16 2012; May 3 2012 and September 28 2012), *available at* <http://www.sec.gov/divisions/corpfin/guidance/cfjjobactfaq-title-i-general.htm> (SEC Title I FAQs).
2. Securities Act § 2(a)(19), 15 USC 77b(a).
3. SEC Title I FAQs, *supra* note 1, at Question 1.
4. *Id.*
5. *Id.*
6. SEC Title I FAQs, *supra* note 1, at Question 23, referencing section 5110.2(c) of the Division of Corporation Finance Financial Reporting Manual, *available at* <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf>.
7. SEC Title I FAQs, *supra* note 1, at Question 51.
8. SEC Title I FAQs, *supra* note 1, at Question 2.
9. *Id.*
10. SEC Title I FAQs, *supra* note 1, at Questions 19-21.
11. SEC Title I FAQs, *supra* note 1, at Question 24.
12. SEC Title I FAQs, *supra* note 1, at Question 54.
13. Securities Act § 2(a)(19), 15 USC 77b(a).
14. SEC Title I FAQs, *supra* note 1, at Question 17.
15. *Id.*
16. SEC Title I FAQs, *supra* note 1, at Question 18.
17. SEC Title I FAQs, *supra* note 1, at Question 47.
18. SEC Title I FAQs, *supra* note 1, at Question 3.
19. *Id.*
20. JOBS Act §105(c), amending Securities Act § 5, 15 USC 77e.
21. Without the availability of the test-the-waters provisions in Securities Act § 5(d), an issuer could potentially be deemed to be “gun jumping” when communicating with investors about an actual or potential offering, based on the timing and nature of such communications.
22. Frequently Asked Questions About Research Analysts and Underwriters (August 22 2012), *available at* <http://www.sec.gov/divisions/marketreg/tmjjobsact-researchanalystsfaq.htm>, at Question 1.
23. Sections 105(c) and 105(d) of the JOBS Act.
24. Section 106(a) of the JOBS Act, amending Securities Act § 6, 15 USC 77(f). A foreign private issuer that qualifies as an EGC may opt to use the Division of Corporation Finance’s policy titled *Non-Public Submissions from Foreign Private Issuers* if they meet the circumstances that the Division has outlined in that policy, *available at* <http://www.sec.gov/divisions/corpfin/internatl/nonpublicsubmissions.htm>.
25. For this purpose, the term “road show” is defined in Securities Act Rule 433(h)(4).
26. Frequently Asked Questions on the Confidential Submission Process for Emerging Growth Companies (April 10 2012), *available at* <http://www.sec.gov/divisions/corpfin/guidance/cfjumpsstartfaq.htm> (SEC Confidential Submission FAQs), at Question 5.
27. SEC FAQs, *supra* note 1, at Question 52.
28. *Id.*
29. SEC Confidential Submission FAQs, *supra* note 26, at Question 7.
30. SEC Confidential Submission FAQs, *supra* note 26, at Question 6.
31. Securities Act Rule 433(h)(4).
32. SEC Confidential Submission FAQs, *supra* note 26, at Question 8.
33. SEC Confidential Submission FAQs, *supra* note 26, at Question 9.
34. SEC Title I FAQs, *supra* note 1, at Question 4.
35. Securities Act § 7(a)(2)(A), 15 USC 77g(a)(2)(A).
36. SEC Title I FAQs, *supra* note 1, at Question 11. The SEC would not object if an issuer that has lost its EGC status does not present, in subsequently filed registration statements and periodic reports, selected financial data or a ratio of earnings to fixed charges for periods before the earliest audited period presented in its initial Securities Act or Exchange Act registration statement. *See* SEC Title I FAQs, *supra* note 1, at Question 50.
37. SEC Title I FAQs, *supra* note 1, at Question 16.
38. SEC Title I FAQs, *supra* note 1, at Question 27.
39. JOBS Act §102(c).
40. Exchange Act § 14A(e), 15 USC 78n-1(e).
41. *Id.*
42. *See* Dodd-Frank Act § 953(b)(1).
43. SEC Title I FAQs, *supra* note 1, at Question 13.
44. JOBS Act § 104, amending Sarbanes-Oxley Act § 103(a)(3).
45. JOBS Act § 103, amending Sarbanes-Oxley Act § 404(b).

46. JOBS Act § 107.
47. SEC Title I FAQs, *supra* note 1, at Question 8.
48. JOBS Act § 106(b).
49. JOBS Act § 108.
50. Report to Congress on Decimalisation (July 2012),
available at
<http://www.sec.gov/news/studies/2012/decimalisation-072012.pdf>.
51. Report on Review of Disclosure Requirements in Regulation S-K (December 2013), *available at*
<http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf>.
52. *See* speech of Chair Mary Jo White titled “The Path Forward on Disclosure” (October 15 2013),
available at
<http://www.sec.gov/News/Speech/Detail/Speech/1370539878806#.UwIpxDEo514>.

CHAPTER 2

The IPO process

As we discussed in the Introduction, there are important considerations to be analysed in connection with pursuing an IPO. Even given many changes in the capital markets, and the improved liquidity of private or restricted securities, there are significant advantages to be gained as a result of being a public company. Aside from the immediate capital-raising opportunity of the IPO, going public will create a liquid public market for the issuer's securities. The issuer's security holders will have an opportunity to monetise their investment in the company. The issuer also will have an acquisition currency and be able to use its stock as consideration in a strategic transaction. After the IPO, the issuer also will have many more capital-raising alternatives. All of these advantages will have to be weighed carefully against the costs of undertaking an IPO, as well as the burdens and expense of life as a public company. A bit of this calculus has been made easier for companies that qualify as EGCs. An EGC will have the opportunity to pursue an IPO through an initial confidential submission process. Should the issuer determine that the market will not be receptive to the offering, or that other alternatives are more appealing, it can withdraw from the process without the stigma of a failed deal. In addition, an EGC may benefit from the disclosure accommodations made available by the JOBS Act. As a public company, an EGC also will have the opportunity to ease into many corporate governance requirements. This phase-in approach may result in important cost-savings for an EGC. Also, the EGC will have the benefit of getting accustomed to life as a public company and adding additional staff or retaining service providers before it has to comply with some of the more burdensome requirements.

In addition to changing some of the dynamics that might figure into an issuer's decision-making about an IPO, the JOBS Act also has changed the IPO process itself for EGCs. Below, we discuss briefly the IPO process and highlight along the way a number of the most important decisions that an EGC should consider, and conclude by discussing the opportunities for an issuer that qualifies as a foreign private issuer, or FPI, arising from the JOBS Act.

Pre-IPO planning

Even though an EGC will have an opportunity to submit its IPO registration statement through the confidential submission process, and proceed on a confidential basis without a public filing, the issuer will still have to undertake a fair bit of planning before committing to proceed with a filing.

Most companies will have to make legal and operational changes before proceeding with an IPO. A company cannot wait to see if its IPO is likely to be successful before implementing most of these changes. Many corporate governance matters, federal securities law requirements (including Sarbanes-Oxley) as well as applicable securities exchange requirements must be met when the IPO registration statement is filed, or the issuer must commit to satisfy them within a set time period.

A company proposing to list securities on an exchange should review differing governance requirements of each exchange, as well as their respective financial listing requirements before determining which exchange to choose. Similarly, an issuer will want to consider whether to retain additional senior management or enter into employment agreements with key executive officers and systematise its compensation practices. An issuer must also address other corporate governance matters, including board structure, committees and member criteria, related-party transactions, and director and officer liability insurance. The company should undertake a thorough review of its compensation scheme for its directors and officers, as well, particularly its use of equity compensation. The issuer also will want to review all prior securities issuances for compliance with federal and state securities laws, including the limits of Rule 701.

Primary and secondary offerings

An IPO may consist of the sale of newly issued shares by the company (a primary offering), or a sale of already issued shares owned by shareholders (a secondary offering), or a combination of these. Underwriters may prefer a primary offering because the company will retain all of the proceeds to advance its business. However, many IPOs include secondary shares, either in the initial part of the offering or as part of the 15% over-allotment option

granted to underwriters. Venture capital and private equity shareholders view a secondary offering as their principal realisation event. An issuer must consider whether any of its shareholders have registration rights that could require the issuer to register shareholder shares for sale in the IPO.

Cheap stock

“Cheap stock” describes options granted to employees of a pre-IPO company during the 18–24 months before the IPO where the exercise price is deemed (in hindsight) to be considerably lower than the fair market value of the shares at grant date. If the SEC determines (during the comment process) that the company has issued cheap stock, the company must incur a compensation expense that will have a negative impact on earnings. The earnings impact may result in a significant one-time charge at the time of the IPO as well as going-forward expenses incurred over the option vesting period. In addition, absent certain limitations on exercisability, an option granted with an exercise price that is less than 100% of the fair market value of the underlying stock on the grant date will subject the option holder to an additional 20% tax pursuant to section 409A of the Internal Revenue Code.

The dilemma that a private company faces is that it is unable to predict with certainty the eventual IPO price. A good-faith pre-IPO fair market value analysis can yield different conclusions when compared to a fair market value analysis conducted by the SEC in hindsight based on a known IPO price. There is some industry confusion as to the acceptable method for calculating the fair market value of non-publicly traded shares and how much deviation from this value is permitted by the SEC. Companies often address this cheap stock concern by retaining an independent appraiser to value their stock options. It now appears, however, that most companies are using one of the safe-harbour methods for valuing shares prescribed in the section 409A regulations.

Governance and board members

Even with the accommodations available to an EGC, a company still must comply with significant corporate governance requirements imposed by the federal securities laws and regulations and the regulations of the applicable exchanges, including with regard to the oversight responsibilities of the board of directors and its committees. A critical matter is the composition of the board itself. All exchanges require that, except under limited circumstances, a majority of the directors be “independent” as defined by both the federal securities laws and regulations and exchange regulations. In addition, boards should include individuals with

appropriate financial expertise and industry experience, as well as an understanding of risk management issues and public company experience. A company should begin its search for suitable directors early in the IPO process even if it will not appoint the directors until after the IPO is completed. The company can turn to its large investors as well as its counsel and underwriters for references regarding potential directors.

The Sarbanes-Oxley Act and the Dodd-Frank Act require publicly traded companies to implement corporate governance policies and procedures that are intended to provide minimum structural safeguards to investors. Certain of these requirements are phased in after the IPO. Again, quite a number of these requirements will be applicable to an EGC and should be carefully considered. Key provisions include:

- Prohibition of most loans to directors and executive officers (and equivalents thereof).
- The CEO and CFO of a public company must certify each SEC periodic report containing financial statements.
- Adoption of a code of business conduct and ethics for directors and senior executive officers.
- Required “real time” reporting of certain material events relating to the company’s financial condition or operations.
- Disclosure of whether the company has an “audit committee financial expert” serving on its audit committee.
- Disclosure of material off-balance sheet arrangements and contractual obligations.
- Audit committee approval of any services provided to the company by its audit firm, with certain exceptions for *de minimis* services.
- Whistleblower protections for employees who come forward with information relating to federal securities law violations.
- Compensation disgorgement provisions applicable to the CEO and CFO upon a restatement of financial results attributable to misconduct.
- The exchanges’ listing requirements contain related substantive corporate governance requirements regarding independent directors; audit, nomination, and compensation committees; and other matters.

Selecting the underwriters

A company will identify one or more lead underwriters that will be responsible for the IPO. A company chooses an underwriter based on its industry expertise, including the knowledge and following of its research analysts, the breadth of its distribution capacity, and its overall

reputation. A company should consider the underwriter's commitment to the sector and its distribution strengths. For example, does the investment bank have a particularly strong research distribution network, or is it focused on institutional distribution? Is its strength domestic, or does it have foreign distribution capacity? The company may want to include a number of co-managers in order to balance the underwriters' respective strengths and weaknesses.

A company should keep in mind that underwriters have at least two conflicting responsibilities: to sell the IPO shares on behalf of the company and to recommend to potential investors that the purchase of the IPO shares is a suitable and a worthy investment. In order to better understand the company – and to provide a defence in case the underwriters are sued in connection with the IPO – the underwriters and their counsel are likely to spend a substantial amount of time performing business, financial, and legal due diligence in connection with the IPO, and making sure that the prospectus and any other offering materials are consistent with the information provided. The underwriters will market the IPO shares, set the price (in consultation with the company) at which the shares will be offered to the public and, in a so-called firm commitment underwriting, purchase the shares from the company and then re-sell them to investors. In order to ensure an orderly market for the IPO shares, after the shares are priced and sold, the underwriters are permitted in many circumstances to engage in certain stabilising transactions to support the stock.

The IPO process

The public offering process is divided into three periods:

- the pre-filing period between determining to proceed with a public offering and the actual SEC filing of the registration statement; the company is in the “quiet period” and subject to potential limits on public disclosure relating to the offering;
- the waiting or pre-effective period between the SEC filing date and the effective date of the registration statement; during this period, the company may make oral offers, but may not enter into binding agreements to sell the offered security; and
- the post-effective period between effectiveness and completion of the offering.

The registration statement

A registration statement contains the prospectus, which is the primary selling document, as well as other required information, written undertakings of the issuer and the signatures of the issuer and the majority of the issuer's

directors. It also contains exhibits, including basic corporate documents and material contracts. US companies generally file a registration statement on Form S-1. Most non-Canadian foreign private issuers use a registration statement on Form F-1, although other forms may be available. There are special forms available to certain Canadian companies.

The prospectus

The prospectus describes the offering terms, the anticipated use of proceeds, the company, its industry, business, management and ownership, and its results of operations and financial condition. Although it is principally a disclosure document, the prospectus also is crucial to the selling process. A good prospectus sets forth the investment proposition.

As a disclosure document, the prospectus functions as an insurance policy of sorts in that it is intended to limit the issuer's and underwriters' potential liability to IPO purchasers. If the prospectus contains all SEC-required information, includes robust risk factors that explain the risks that the company faces, and has no material misstatements or omissions, investors will not be able to recover their losses in a lawsuit if the price of the stock drops following the IPO. A prospectus should not include puffery or overly optimistic or unsupported statements about the company's future performance. Rather, it should contain a balanced discussion of the company's business, along with a detailed discussion of risks and operating and financial trends that may affect its results of operations and prospects.

SEC rules set forth a substantial number of specific disclosures required to be made in the prospectus. In addition, federal securities laws, particularly Rule 10b-5 under the Exchange Act, require that documents used to sell a security contain all the information material to an investment decision and do not omit any information necessary to avoid misleading potential investors. Federal securities laws do not define materiality; the basic standard for determining whether information is material is whether a reasonable investor would consider the particular information important in making an investment decision. That simple statement is often difficult to apply in practice.

An issuer should be prepared for the time-consuming drafting process, during which the issuer, investment bankers, and their respective counsel work together to craft the prospectus disclosure.

Financial information

The IPO registration statement for an EGC must include

audited financial statements for the last two fiscal years; financial statements for the most recent fiscal interim period, comparative with interim financial information for the corresponding prior fiscal period (may or may not be audited depending on the circumstances); and income statement and condensed balance sheet information for the last two years and interim periods presented.

Early on, the issuer should identify any problems associated with providing the required financial statements in order to seek necessary accommodation from the SEC. These statements must be prepared in accordance with US GAAP or IFRS as adopted by the IASB, as they will be the source of information for Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The SEC will review and comment on the financial statements and the MD&A. The SEC's areas of particular concern include: revenue recognition; business combinations; segment reporting; financial instruments; impairments of all kinds; deferred tax valuation allowances; compliance with debt covenants; fair value; and loan losses.

The pre-filing period

The pre-filing period begins when the company and the underwriters agree to proceed with a public offering. During this period, key management personnel will generally make a series of presentations covering the company's business and industry, market opportunities, and financial matters. The underwriters will use these presentations as an opportunity to ask questions and establish a basis for their due diligence defence.

From the first all-hands meeting forward, all statements concerning the company should be reviewed by the company's counsel to ensure compliance with applicable rules. Communications by an issuer more than 30 days before filing a registration statement are permitted as long as they do not reference the securities offering. Statements made within 30 days of filing a registration statement that could be considered an attempt to pre-sell the public offering may be considered an illegal prospectus, creating a gun-jumping violation. This might result in the SEC's delaying the public offering or requiring prospectus disclosures of these potential securities law violations. Press interviews, participation in investment banker-sponsored conferences, and new advertising campaigns are generally discouraged during this period.

In general, at least four to six weeks will pass between the distribution of a first draft of the registration statement and its filing with the SEC. To a large extent, the length of the pre-filing period will be determined by the amount of time required to obtain the required financial statements.

The waiting period

Responding to SEC comments on the registration statement

The SEC targets 30 calendar days from the registration statement filing date to respond with comments. The SEC review process has not changed as a result of the JOBS Act, although the issuer should anticipate that it will receive comments from the SEC staff regarding its EGC-related disclosures. Once the registration statement is submitted, a team of SEC staff members is assigned to review the filing. The team consists of accountants and lawyers, including examiners and supervisors. The SEC's objective is to assess the company's compliance with its registration and disclosure rules.

It is not unusual for the first SEC comment letter to contain a significant number of comments to which the issuer must respond both in a letter and by amending the registration statement.

The SEC's principal focus during the review process is on disclosure. In addition to assessing compliance with applicable requirements, the SEC considers the disclosures through the eyes of an investor in order to determine the type of information that would be considered material. The SEC's review is not limited to the registration statement. The staff will closely review websites, databases, and magazine and newspaper articles, looking in particular for information that the staff thinks should be in the prospectus or that contradicts information included in the prospectus.

It is easy to anticipate many of the matters that the SEC will raise in the comment process. The SEC makes the comment letters and responses from prior reviews available on its website, so it is possible to determine the most typical comments arising during the IPO process. Overall, the SEC staff looks for a balanced, clear presentation of the information required in the registration statement. Some of the most frequent comments raised by the SEC staff on disclosure, other than the financial statements, include:

Front cover and gatefold: Has the EGC included disclosure on the front cover identifying itself as an EGC? Given that a number of issuers that are EGCs have completed their IPOs, an EGC pursuing an IPO may review its filings and see the type of language that the SEC staff expects to see on the cover page. For an issuer that chooses to use artwork, the SEC staff will consider whether the artwork presents a balanced presentation of the company's business, products, or customers?

Prospectus summary: Is the presentation balanced? Again, in the summary section, the SEC staff will expect to see a brief discussion that identifies that the issuer is an EGC and is electing to rely on certain accommodations available to EGCs.

Risk factors: Are the risks specific to the company and devoid of mitigating language? The SEC also will expect to see certain risk factors relating to the issuer's status as an EGC.

Use of proceeds: Is there a specific allocation of the proceeds among identified uses, and if funding acquisitions is a designated use, are acquisition plans identified?

Selected financial data: Does the presentation of non-GAAP financial measures comply with SEC rules?

MD&A: Does the discussion address known trends, events, commitments, demands, or uncertainties, including the impact of the economy, trends with respect to liquidity, and critical accounting estimates and policies?

Business: Does the company provide support for statements about market position and other industry or comparative data? Is the disclosure free of, or does it explain, business jargon? Are the relationships with customers and suppliers, including concentration risk, clearly described?

Underwriting: Is there sufficient disclosure about stabilisation activities (including naked short selling), as well as factors considered in early termination of lockups and any material relationships with the underwriters?

Exhibits: Do any other contracts need to be filed based on disclosure in the prospectus?

After the SEC has provided its initial set of comments, it is much easier to determine when the registration process is likely to be completed and the offering can be made. In most cases, the underwriters prefer to delay the offering process and to avoid distributing a preliminary prospectus until the SEC has reviewed at least the first filing and all material changes suggested by the SEC staff have been addressed.

Preparing the underwriting agreement, comfort letter and other documents

During the waiting period, the company, the underwriters and their counsel, and the company's independent auditor will negotiate a number of agreements and other documents, particularly the underwriting agreement and the auditor's comfort letter.

The underwriting agreement is the agreement pursuant to which the company agrees to sell, and the underwriters agree to buy, the shares and then sell them to the public; until this agreement is signed, the underwriters do not have an enforceable obligation to acquire the offered shares. The underwriting agreement is not signed until the offering is priced. In the typical IPO, the underwriters will have a "firm commitment" to buy the shares once they sign the underwriting agreement.

Underwriters' counsel will submit the underwriting agreement, the registration statement, and other offering documents for review to the Financial Industry Regulatory Authority (Finra), which is responsible for reviewing the terms of the offering to ensure that they comply with Finra requirements. An IPO cannot proceed until the underwriting arrangement terms have been approved by Finra.

In the comfort letter, the auditor affirms its independence from the issuer, and the compliance of the financial statements with applicable accounting requirements and SEC regulations. The auditor also will note period-to-period changes in certain financial items. These statements follow prescribed forms and are usually not the subject of significant negotiation. The underwriters will also usually require that the auditor undertake certain agreed-upon procedures in which it compares financial information in the prospectus (outside of the financial statements) to the issuer's accounting records to confirm its accuracy.

Marketing the offering

During the waiting period, marketing begins. Before the JOBS Act, it was the case that the only written sales materials that could be distributed during this period were the preliminary prospectus and additional materials known as "free writing prospectuses," which must satisfy specified SEC requirements. Binding commitments cannot be made during this period. The underwriters will receive indications of interest from potential purchasers, indicating the price they would be willing to pay and the number of shares they would purchase. Once SEC comments are resolved, or it is clear that there are no material open issues, the issuer and underwriters will undertake a two- to three-week road show, during which company management will meet with prospective investors.

Once SEC comments are cleared and the underwriters have assembled indications of interest for the offered securities, the company and its counsel will request that the SEC declare the registration statement effective at a certain date and time, usually after the close of business of the US securities markets on the date scheduled for pricing the offering.

The post-effective period

Once the registration statement has been declared effective and the offering has been priced, the issuer and the managing underwriters execute the underwriting agreement and the auditor delivers the final comfort letter. This occurs after pricing and before the opening of trading

on the following day. The issuer then files a final prospectus with the SEC that contains the final offering information.

On the third or fourth business day following pricing, the closing occurs, the shares are issued, and the issuer receives the proceeds. The closing completes the offering process. Then, for the following 25 days, aftermarket sales of shares by dealers must be accompanied by the final prospectus or a notice with respect to its availability. If during this period there is a material change that would make the prospectus misleading, the issuer must file an amended prospectus.

SPECIAL JOBS ACT-RELATED CONSIDERATIONS

Confidential submissions

As explained in Chapter 1, an EGC may make a confidential submission of its registration statement, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the commencement of the issuer's road show.

Although an EGC may file confidentially, and a confidentially-submitted draft registration statement is not required to be signed by the issuer and its officers or directors, nor is it required to contain a signed auditors' consent, the confidential submission should be a complete registration statement. The SEC may decide not to review a draft submission that is deemed incomplete or materially deficient. This will just slow down the IPO process. Moreover, the issuer and its advisers should understand, as noted above, that the initial confidential submission will become publicly available. As a result, the issuer, its advisers and the entire working group should approach the preparation of a confidential submission with the same rigour as they would approach the preparation of a registration statement that will be publicly filed and available to all, including the issuer's competitors.

There are few, if any, disadvantages to the confidential submission process. An issuer will be able to make a confidential submission and proceed with the review process without the glare of publicity, and without having competitors become aware of the proposed offering. The issuer will have greater flexibility to control the timing of the offering. If the market seems inhospitable to an offering, the issuer may decide to delay the process and will not subject itself to public scrutiny for doing so. If the issuer needs to withdraw the filing, again, it will be able to do so without the stigma associated with a failed or withdrawn offering.

An issuer and its bankers and advisers may not, however, have as much insight into the IPO market given the confidential filing process. For example, bankers may not be aware of competitors (that are EGCs) that also are pursuing IPOs because the competitors also may be proceeding with their offerings on a confidential basis. Often having information about other companies in the IPO queue may be important because it may factor into decisions on timing of marketing the deal, as well as decisions regarding valuation.

Often an issuer will decide to pursue a dual-track approach, whereby it will decide to undertake an IPO and also consider M&A alternatives. The IPO filings often serve to make acquisitive competitors that may be interested in new opportunities aware of the issuer and the issuer's performance. It may be more difficult to pursue a dual-track strategy during the confidential submission process. Of course, an issuer that is relying on the confidential submission process may choose to make an announcement regarding its intentions to pursue an IPO, and a few companies have issued such press releases. Since the confidentiality obligation rests with the SEC, and not with the issuer, a press release of this sort is permissible, although it should be considered carefully given that it undoes many of the benefits associated with the confidential process.

Marketing the offering

Section 5(c) of the Securities Act prohibits offers of a security before a registration statement is filed. While gun-jumping can be a serious concern, the 2005 safe harbours created by Securities Offering Reform have provided considerable guidance to companies about this issue. Further, the ability of EGCs to test-the-waters before filing, together with the elimination of the ban on general solicitation in connection with certain private placements also effected by the JOBS Act have also significantly reduced concerns about gun-jumping. In addition, the confidential submission of a draft registration does not constitute the filing of a registration statement for the purposes of the prohibition in Securities Act section 5(c) against making offers of a security in advance of filing a registration statement.¹

Section 5(b)(1) prohibits written offers other than by means of a prospectus that meets the requirements of section 10 of the Securities Act, such as a preliminary prospectus. The bans are designed to prohibit inappropriate marketing, conditioning or hyping of the security before all investors have access to publicly available information about the company so that they can make informed investment decisions. From the first all-hands

organisational meeting forward, all statements concerning the company should be reviewed by the company's counsel to ensure compliance with applicable rules.

Testing the waters

The JOBS Act provides an EGC or any other person, such as its underwriter, that it authorises to act on its behalf with the flexibility to engage in oral or written communications with QIBs and institutional accredited investors in order to gauge their interest in a proposed offering, whether before (irrespective of the 30-day communications safe harbour) or following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a section 10(a) prospectus.

An EGC may use the testing-the-waters provision with respect to any registered offerings that it conducts while it qualifies for EGC status. There are no form or content restrictions on these communications, and there is no requirement to file written communications with the SEC. The SEC staff will ask to see any written test-the-waters materials during the course of the registration statement review process to determine whether those materials provide any guidance as to information that the SEC staff believes should be included in the prospectus.

The JOBS Act does not amend section 5(b)(1) of the Securities Act, which requires that written offers must include the information required by section 10. Therefore, in order to make written offers, an EGC or a foreign private issuer must first file (not just submit) its registration statement with the SEC and have a preliminary prospectus available, irrespective of the expected commencement of the road show. In the pre-filing period, test-the-waters communications must be limited to QIBs and institutional investors, since even an EGC cannot make offers to the public until it files the registration statement publicly.

Before engaging in any test-the-waters discussions, an EGC should consult with its counsel and coordinate closely with the underwriter. As noted above, during the comment process, the SEC staff will ask whether the issuer engaged in testing the waters, and will want to see any written materials used for this purpose. In addition, as we discuss below, issuer's counsel and the underwriter and its counsel will want an opportunity to review and comment on the material. Any written materials used for this purpose should be consistent with the information included in the issuer's registration statement. An issuer also will want to be certain that the issuer is not sharing any information that may be deemed confidential in the course of these discussions. An investor approached during

this phase generally will not want to be in possession of any information that will remain confidential, and that may be material, even following the issuer's IPO. In addition, as discussed further below, an issuer will be required to make certain representations and warranties to the underwriters in the underwriting agreement relating to any test-the-waters activities and materials.

Many companies contemplating an IPO in the United States, especially foreign private issuers, were surprised by the restrictions on offering related communications imposed by SEC regulations. Critics noted that these communications restrictions limited an issuer's opportunity to reach potential investors early in the process and, therefore, an issuer was forced to incur significant expense in pursuing an IPO and might not have any information about the level of investor interest and potential valuations until the road show. In other jurisdictions, especially in Europe and Asia, issuers and the financial intermediaries acting on their behalf have considerably more flexibility. Often in European or Asian offerings, a lead or cornerstone investor might be secured early in the offering process. As a result of these concerns, the ability to conduct test-the-waters communications was well received. In practice, however, we understand that few EGCs are conducting these conversations early in the offering process. To the extent that EGCs are benefiting from the enhanced flexibility, the test-the-waters conversations are taking place shortly before the commencement of the road show, and not early in the offering process. It may be that, over time, the market will adapt and test-the-waters communications may become more commonplace.

It is also important to remember that the test-the-waters flexibility still is more limited than the approach that may be familiar to foreign issuers. As noted in Chapter 1, during the test-the-waters phase an EGC may engage in discussions with institutional investors but the EGC and the underwriter cannot obtain a purchase commitment. The underwriter may discuss price, volume and market demand and solicit non-binding indications of interest from customers.

Private offerings during the IPO process

An issuer may need to raise capital while it is pursuing an IPO. Historically, there was some concern about concurrent offerings. An issuer that had publicly filed a registration statement had to consider carefully with its counsel whether the public filing constituted a general solicitation that precluded the issuer from availing itself of the private placement exemption to complete a financing during the pendency of its IPO. For some time,

practitioners relied on existing no-action letter guidance that was somewhat narrowly construed as permitting a concurrent private placement to QIBs and to a handful of institutional accredited investors.² This fairly limited approach was modified over time and a more expansive view was expressed by the SEC first in 2007 and confirmed in Compliance and Disclosure Interpretations.³ The C&DI, confirming the guidance in the SEC's 2007 release, provides that

under appropriate circumstances, there can be a side-by-side private offering under Securities Act section [4(a)(2)] or the Securities Act Rule 506 safe harbor with a registered public offering without having to limit the private offering to qualified institutional buyers and two or three additional large institutional accredited investors, as under the Black Box (June 26, 1990) and Squadron, Ellenoff (Feb. 28, 1992) no-action letters issued by the Division, or to a company's key officers and directors, as under our so-called "Macy's" position.⁴

The SEC also clarified that a company can make a valid private placement if the investors are identified by means other than the registration statement.

Given this viewpoint, and even without considering the relaxation of the prohibition on general solicitation in respect of certain Rule 506 offerings, it is clear that an EGC could either during the confidential phase or after the public filing of its registration statement contact institutional investors and discuss a potential private financing. It is easy to envision that a test-the-waters conversation may morph into a discussion with an institutional investor about a potential private placement. An EGC should take care to be clear in its conversations with potential investors, and ensure that any potential investors understand whether they are participating in a private placement transaction, and purchasing securities that will be restricted securities, and not expressing an interest in participating in the IPO.

The JOBS Act has contributed to a further blurring of the lines between private placements and public offerings given the relaxation of the prohibition against general solicitation and the introduction of exemptions for certain limited offerings pursuant to section 3(b)(2) and crowdfunding.

Flipping from confidential to public

In a typical IPO, the issuer will continue to work with its counsel during the waiting period in order to address the SEC's comments on its filing, and also concurrently work on finalising various ancillary agreements, including the underwriting agreement and lock-up agreements. The underwriter and its counsel usually recommend that an

issuer wait to finalise, and print a preliminary prospectus or red herring until the issuer and its counsel have responded to and addressed all of the significant comments raised by the SEC during the review process. This ensures that the issuer will not have to recirculate its preliminary prospectus as a result of any change arising during the review process. The underwriter will wait to commence the road show until the preliminary prospectus is prepared.

In the case of an EGC IPO, there may be an additional dynamic to be considered. An EGC that is relying on the confidential submission process may want to consider when to make its first "public" filing. As discussed in Chapter 1, and above, an EGC is required to file publicly with the SEC at least 21 days before the commencement of the issuer's road show. The EGC may want to make a public filing before that for a variety of reasons, however. The EGC may want to file publicly earlier in the process, perhaps after it has undergone one or two amendments, in order to have it known to competitors or to strategic investors that the company is proceeding with an IPO and to make the registration statement available freely. This may be helpful if the issuer is contemplating a dual-track approach. It may be helpful in order to permit the underwriter to interest institutional investors in preliminary test-the-waters type discussions. Some institutional investors may be reluctant to commit the time and resources to meeting with a company or evaluating a potential investment if they believe that the offering is in a very preliminary stage. An EGC will want to consult with counsel and consider carefully its decision to transition from a confidential process to a public process.

Disclosures and other accommodations

We noted that one of the principal benefits of the IPO on-ramp approach is that an EGC may choose to rely on some of the disclosure accommodations made available by Title I of the JOBS Act. An EGC may choose to present only two years of audited financial information (and only two years of summary and selected financial data, as well as an abbreviated MD&A discussion) in its registration statement. An EGC and its counsel will want to consider whether the EGC will want to present information for a third year although it is not required. In some cases, the underwriter will have strong views regarding the information that should be presented in the registration statement. For example, the underwriter may take the view that the issuer's competitors that are already SEC-reporting companies provide financial information for a longer period and it will be important to investors that the EGC provide comparable information. The underwriter may

believe that institutional investors in that industry sector may demand three years of financial information. It may be the case that there are important trends in either the issuer's business and results of operations or in the industry as a whole that make it important to present three years of information in order to ensure that an investor will be able to evaluate all of the information that may be deemed material to an investment decision, including, perhaps, trends in the issuer's business or in the industry. According to certain published reports, only a small percentage of EGCs have availed themselves of the ability to provide information for a shorter period.

EGCs also have the option of relying on the smaller reporting company scaled disclosure requirements for executive compensation. This means, for example, that an EGC could omit a Compensation Discussion and Analysis section and present only a summary compensation table. An EGC may decide to include more substantial executive compensation disclosures in its future filings. An EGC should consult with its counsel, as well as with the underwriter, regarding these disclosures.

An EGC also will have to decide whether it will opt out of the extended transition period provided for an EGC to comply with new or revised accounting standards. An EGC's decision in this regard is irrevocable, and will have to be disclosed in its registration statement. Here, again, the issuer will want to consider this decision carefully and discuss it with its counsel and its auditors. The underwriter may also have a view. To date, many EGCs have opted out of the extended transition period, although it is possible that market practice will evolve over time as participants become more accustomed to the JOBS Act provisions.

Underwriting agreements

Underwriting agreements have been revised to address JOBS Act changes. An underwriting agreement for an EGC will contain representations and warranties by the EGC regarding its status as an EGC at each of the relevant times (when it made its confidential submission with the SEC, when it undertook any test-the-waters communications, on the date of execution of the underwriting agreement, and so on). The EGC will be asked to represent that it has not engaged in any test-the-waters communications other than with QIBs or institutional accredited investors, and except as agreed with the underwriters. To the extent that it has distributed written materials, the EGC will be asked to make certain representations regarding the accuracy of those materials. Similarly, the EGC will be asked to make certain covenants to the underwriters, which will include an agreement to notify the underwriters if, at any time before the later of

the time when a prospectus is required to be delivered in connection with the offering, and the completion of the lock-up period, the issuer no longer qualifies as an EGC. In addition, the lock-up language applicable to an EGC also will be revised to account for the quiet period changes included in the JOBS Act.

FOREIGN PRIVATE ISSUERS

Our discussions have focused on US domestic issuers; however, foreign issuers that are considering accessing the US capital markets will have available to them almost all of the benefits of the JOBS Act. A foreign issuer must choose between undertaking a public offering in the United States, which would have the result of subjecting the issuer to ongoing securities reporting and disclosure requirements, and undertaking a limited offering that will not subject the issuer to US reporting obligations. A public offering in the United States offers distinct advantages for foreign issuers. The US public markets remain among the most active and deepest equity markets in the world. In recent years, however, many foreign issuers may have been discouraged by the regulatory burdens associated with being a US reporting company, including those imposed by the Sarbanes-Oxley Act and the Dodd-Frank Act. For foreign issuers that qualify as EGCs, the IPO on-ramp process has made the United States more hospitable. For example, in 2013, there were a total of 222 IPOs with 37 of those involving foreign issuers (30 involving foreign issuers that qualified as EGCs), compared to 128 IPOs with 21 of those involving foreign issuers (12 involving foreign issuers that qualified as EGCs) in 2012.⁵

A foreign private issuer (FPI) is any issuer (other than a foreign government) incorporated or organised under the laws of a jurisdiction outside of the United States, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly by residents of the United States, and any of the following applies: (i) the majority of the issuer's executive offices or directors are United States citizens or residents; (ii) the majority of the issuer's assets are located in the United States; or (iii) the issuer's business is principally administered in the United States.⁶ An FPI may become subject to US securities law reporting requirements either by conducting a public offering in the United States by registering the offering and sale of its securities pursuant to the Securities Act, or by listing a class of its securities on a US national securities exchange through registration pursuant to the Exchange Act or becoming subject to the Exchange Act requirements if a class of its equity securities is held of record by 2,000 or more persons or 500 non-accredited investors.

Important benefits are available to FPIs. For example, an FPI may exit or deregister its securities more easily than a domestic US issuer. An FPI must test its qualification only once a year, and should it fail to qualify as an FPI, it has six months to transition to the US domestic reporting system. US domestic issuers generally must file their annual reports on Form 10-K within three months following the end of their fiscal year. By contrast, an FPI must file its annual report on Form 20-F within four months of the fiscal year covered by the report. This allows an FPI slightly more time to prepare the required information. An FPI has no legal obligation to file quarterly reports. By contrast, US domestic issuers must file a quarterly report on Form 10-Q. Unlike a US domestic issuer, an FPI has no legal obligation to file proxy solicitation materials on Schedule 14A or 14C in connection with annual or special meetings of its security holders. An FPI has no legal obligation to establish an audit committee. The securities exchanges generally provide alternative corporate governance requirements for listed FPIs, which are less burdensome than those for listed US domestic issuers. An FPI is exempt from the SEC's disclosure rules for executive compensation on an individual basis, but is required to provide certain information on an aggregate basis. An FPI may prepare its financial statements in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) without reconciliation to US generally accepted accounting principles (US GAAP).

An FPI may submit its initial registration statement on a confidential basis to the SEC staff if it is listed or is concurrently listing its securities on a non-US securities exchange, it is being privatized by a foreign government, or it can demonstrate that the public filing of the initial registration statement would conflict with the law of an applicable foreign jurisdiction. An FPI may separately use the confidential registration statement review procedures available to an EGC, if it qualifies as an EGC. An FPI can qualify to be treated as an EGC if it has total gross revenues of under \$1 billion during its most recently completed fiscal year. Total annual gross revenues means total revenues as presented on the income statement under US GAAP or IFRS as issued by the IASB, if used as the basis of reporting by an FPI. If the financial statements of an FPI are presented in a currency other than US dollars, total annual gross revenues for purposes of determining whether an FPI is an EGC should be calculated in US dollars using the exchange rate as of the last day of the most recently completed fiscal year.

An FPI seeking to raise capital by selling securities (or

ADRs) in the US must file a registration statement on Form F-1 with the SEC. The registration statement on Form F-1 requires significant disclosure about the foreign issuer's business and operations, and is similar to, but less onerous than, the Form S-1 that most US issuers use for their IPOs. The SEC staff has made clear that an FPI that qualifies as an EGC and that is using a Form F-1 may avail itself of all of the disclosure accommodations available to domestic EGCs. An FPI that is an EGC also may avail itself of all other benefits available to domestic EGCs, including the governance related accommodations, the ability to test-the-waters, and the flexibility to have broker-dealers publish or distribute research reports about the company.

A foreign issuer also may decide to access the US capital markets through an exempt offering, such as an offering to QIBs or an offering made in reliance on Rule 506. Once the SEC rulemaking relating to the relaxation of the prohibition on general solicitation is finalized, foreign issuers will be able to benefit from greater communications flexibility in connection with Rule 506 and Rule 144A offerings. It is not clear whether a foreign issuer will be able to rely on the offering exemption under section 3(b)(2). A foreign issuer cannot rely on the crowdfunding exemption.

MARKET TRENDS RELATING TO JOBS ACT ACCOMMODATIONS

Since the JOBS Act took effect on April 5 2012, there have been a number of trends in the IPO market. Companies electing EGC status come from many industries, although the largest groups of EGC IPO issuers are from the pharmaceutical, technology, real estate, energy and healthcare industries. FPIs also are taking advantage of Title I (approximately 15% of all EGC issuers in 2013). Standard disclosure has been developed by the IPO market regarding the election of EGC status and the chosen IPO on-ramp accommodations. In addition, there have been a number of trends with respect to the IPO on-ramp accommodations chosen by EGC issuers, which we describe below.

Confidential submissions

An EGC may submit its IPO registration statement confidentially in draft form for SEC staff review, provided that the initial confidential submission and all amendments are publicly filed with the SEC within 21 days prior to the commencement of the EGC's roadshow. The confidential submission process permits an EGC to commence the SEC review process without publicly disclosing sensitive strategic, proprietary and financial

information. In addition, in the case of adverse market conditions, weak investor demand in response to testing-the-waters communications or regulatory concerns, an EGC may withdraw its draft registration statement and terminate the IPO process without ever making a public filing, thus removing a potential disincentive to commencing an IPO and permitting the immediate pursuit of a private placement or an M&A transaction instead.

The confidential submission process has been particularly popular among EGCs and has gained market acceptance. The vast majority of EGCs that priced an IPO since the JOBS Act took effect (over 90%) have confidentially submitted at least one draft registration statement prior to publicly filing and the majority of EGCs have submitted at least two draft registration statements prior to making their first public filing. Much of the discussion related to the confidential submission process has been focused on the timing of moving from the confidential submission to the first public filing, which is often based on having the 21-day period run in order to meet the IPO roadshow schedule and the desire to pursue a dual-track IPO/M&A strategy.

The confidential submission process appears thus far to be used primarily to keep the IPO process secret from competitors and the market without having to disclose sensitive strategic, proprietary and financial information. However, not all EGCs have availed themselves of the confidential submission process. Some EGCs have forgone the process based on the belief that a public filing helps attract bidders in the case of a dual-track IPO/M&A strategy. However, a small number of EGCs engaged in a dual-track IPO/M&A strategy have, for strategic reasons, used the confidential submission process and publicly announced the confidential submission in a Securities Act Rule 135 compliant press release (in order to avoid gun-jumping).

Testing-the-waters communications and research coverage

Testing-the-waters communications and research practices also are still evolving. The decision whether, when and how to use testing-the-waters communications is being made on a case-by-case basis by EGC issuers and their underwriters. When testing-the-waters communications have been used, they have been used mainly for “meet the management” presentations rather than presentations regarding valuation. With respect to research practices, although analysts employed by participating broker-dealers may publish research on EGCs earlier than currently allowed for non-EGCs, robust pre-deal research in

connection with EGC IPOs has not emerged. In fact, most offering participants have been voluntarily restricting research publication for an agreed period following EGC IPOs (typically 25 days).

Reduced financial statements and selected financial data

Taking advantage of the scaled financial disclosures has gained some market acceptance, with less than half of all EGCs electing to provide only two years of audited financial statements rather than three years. This contrasts with 2012, where only one quarter of all EGCs elected to provide only two years of audited financial statements, and most included five years of selected financial data. The decision to take advantage of the scaled financial disclosures though is being made on a case-by-case basis, depending on whether the extra year of financial statements is needed to understand the EGC’s “story” (less important in the case of a biotechnology or development stage company) or show investors the EGC’s longer-term trends and historical growth trajectory (more important for a company with an operating history).

Extended transition for new or revised GAAP accounting pronouncements

EGCs are not required to comply with new or revised GAAP accounting pronouncements until those pronouncements apply to private companies, giving EGCs a longer transition than public companies in situations where a different effective date exists for a GAAP accounting pronouncement specified for private companies. However, the majority of EGCs have not taken advantage of this extended transition period for compliance with new or revised GAAP accounting pronouncements because it might create an unfavourable comparison with competitors and the EGC’s IPO registration statement must still satisfy the relevant Regulation S-X requirements.

Scaled executive compensation disclosures

EGCs are permitted to provide scaled executive compensation disclosure under the requirements generally available to smaller reporting companies. As a result, an EGC may: (1) omit the detailed Compensation Discussion and Analysis (CD&A); (2) provide compensation disclosure covering the top three (including the CEO), rather than the top five, executive officers for a period of two years as compared to three years; and (3) omit four of the six executive compensation tables required for larger companies. The vast majority of EGC IPO issuers in 2013 that otherwise would have been required to include

traditional executive compensation disclosures (ie issuers other than FPIs, externally managed Reits, commodity pools, etc) elected to take advantage of the reduced disclosure, with many omitting the CD&A section and including only a Summary Compensation Table and Outstanding Equity Awards Table covering three rather than five named executive officers and limiting the tabular disclosures to two years.

Exemption from auditor attestation report

EGCs are exempt from the requirements under Sarbanes-Oxley Act section 404(b) to have an auditor attest to the quality and reliability of the company's internal control over financial reporting, and the exemption remains valid for so long as the company retains its EGC status. In contrast, all other newly public companies, regardless of size, generally have until their second annual report to provide the auditor attestation report, and smaller public companies (generally those with a public float of less than \$75 million) are permanently exempted. Almost all EGCs have indicated that they intend to take advantage of (or reserve the right to do so in the future) the exemption from providing the auditor attestation report under Sarbanes-Oxley Act section 404(b).

ENDNOTES

1. SEC Confidential Submission FAQs, *supra* note 26, at Question 6.
2. *See, e.g.*, Division of Corporation Finance no-action letters to Black Box Incorporated (June 26 1990) and Squadron Ellenoff, Pleasant & Lehrer (February 28 1992).
3. The SEC's integration guidance can be found in the Regulation D Proposing Release, *Revisions of Limited Offering Exemptions in Regulation D, 33-8828* (August 3 2007), *available at* <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>, pp. 52-56. *See also* the SEC's Compliance and Disclosure Interpretations – Securities Act Sections (last updated November 26 2008), Question 139.25.
4. *See, e.g.*, C&DI – Securities Act Sections, Question 139.25.
5. For more information regarding the U.S. IPO market, *see* “Current state of the U.S. IPO market” in Chapter 9 (Other capital formation discussions).
6. Exchange Act Rule 3b-4(c). An FPI is permitted to assess its status as an FPI once a year on the last business day of its second fiscal quarter, rather than on a continuous basis, and may avail itself of the FPI accommodations, including use of the FPI forms and reporting requirements, beginning on the determination date on which it establishes its eligibility as an FPI. If an FPI determines that it no longer qualifies as an FPI, it must comply with the reporting requirements and use the forms prescribed by US domestic companies beginning on the first day of the fiscal year following the determination date. SEC Release No. 33-8959. Note that if an FPI loses its status as an FPI it will be subject to the reporting requirements for a US domestic issuer, and while previous SEC filings do not have to be amended upon the loss of such status, all future filings would be required to comply with the requirements for a US domestic issuer. “Financial Reporting Manual,” Division of Corporation Finance, Topic 6120.2, *available at* <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml>. Also note that if an FPI is reincorporated as a US entity, a registration statement on a domestic form (Form S-4) will be required for the exchange of shares with the new US domestic issuer. *Id.* at Topic 6120.8.

CHAPTER 3

Applying Title I to other transactions

While Title I of the JOBS Act is largely focused on capital-raising transactions, there is nothing in the JOBS Act or in the SEC's interpretations to suggest that the IPO on-ramp provisions in Title I should not also apply in the context of other transactions conducted by EGCs pursuant to a Securities Act registration statement. The SEC's Division of Corporation Finance has provided guidance in the form of frequently asked questions indicating that EGCs may rely on certain of the disclosure, communications and confidential submission benefits for EGCs in the context of merger and exchange offer transactions.¹ An overriding principle of the guidance in these FAQs is that an EGC which avails itself of the Title I provisions in the context of an exchange offer or a merger must comply with all of the pre-existing applicable rules for tender offers and proxy solicitations, which might, in some cases, conflict with the more liberal communications approach contemplated by Title I of the JOBS Act. The SEC has also provided guidance regarding the EGC status of issuers that are spun off from SEC reporting issuers.

Availability of test-the-waters communications

As discussed in Chapter 1, Title I of the JOBS Act provides EGCs, or any other person authorised to act on their behalf, the flexibility to engage in oral or written communications with QIBs and institutional accredited investors in order to gauge their interest in a proposed offering, whether before or following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a prospectus.² An EGC could use this test-the-waters provision with respect to any registered offerings that it conducts while it qualifies for EGC status. There are no form or content restrictions on these communications, and there is no requirement to file written communications with the SEC (although the SEC staff requests that written communications be submitted to them when they review an EGC's registration statement).

The SEC has confirmed that an EGC may use test-the-waters communications with QIBs and institutional

accredited investors pursuant to Securities Act section 5(d) in connection with an exchange offer or merger.³ In addition, the SEC staff notes that an EGC must make all required filings under the Exchange Act for any written communications made in connection with, or relating to, the exchange offer or merger. In this regard, the SEC notes that the JOBS Act did not amend the exchange offer or merger requirements under the Exchange Act, such as filings required under Exchange Act Rules 13e-4(c), 14a-12(b), and 14d-2(b), for pre-commencement tender offer communications and proxy soliciting materials in connection with a business combination transaction.

Confidential draft registration statement submissions

As discussed in Chapter 1, Title I added paragraph (e) to section 6 of the Securities Act to provide that the SEC must review all EGC initial public offering registration statements confidentially, if an EGC chooses to submit a draft registration statement to the SEC. An EGC may confidentially submit a draft registration statement for an initial public offering for non-public review, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the issuer's commencement of a road show.⁴

The SEC has indicated that an EGC may use the confidential submission process in section 6(e) of the Securities Act to submit a draft registration statement for an exchange offer or a merger that constitutes its initial public offering of common equity securities.⁵ If an EGC uses the confidential submission process to submit a draft registration statement for an exchange offer or merger that constitutes its initial public offering of common equity securities, the SEC notes a number of obligations under the Securities Act and Exchange Act with respect to the transaction.

If an EGC does not commence its exchange offer before the effectiveness of the registration statement, the EGC must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 21 days before the earlier of the commencement date of the road show, if any, or the

anticipated date of effectiveness of the registration statement. This applies in the case of all exchange offers that do not use early commencement, including those that do not qualify for early commencement under the provisions of Rules 13e-4(e)(2) and 14d-4(b) regarding going-private transactions and roll-up transactions.

An EGC that commences its exchange offer before effectiveness of the registration statement pursuant to Securities Act Rule 162 must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 21 days before the earlier of: the commencement date of the road show, if any, or the anticipated date of effectiveness of the registration statement, but no later than the date of commencement of the exchange offer in light of the filing requirement under Exchange Act Rules 13e-4(e)(2) and 14d-4(b).

For the early commencement of exchange offers subject only to Regulation 14E, an EGC must file its registration statement at least 21 days before the earlier of the commencement date of the road show, if any, or the anticipated date of effectiveness of the registration statement, but no later than the date of commencement of the exchange offer.

An EGC must also make the required filings under Securities Act Rule 425 (unless it is relying on the Securities Act section 5(d) provision for test-the-waters communications) and Exchange Act Rules 13e-4(c) and 14d-2(b) for pre-commencement tender offer communications. An EGC must also file the tender offer statement on Schedule TO on the date of commencement of the exchange offer under Exchange Act Rules 13e-4(b) and 14d-3(a), as applicable.

In a merger where the target company is subject to Regulation 14A or 14C and the registration statement of the EGC acquirer includes a prospectus that also serves as the target issuer's proxy or information statement, the acquirer must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 21 days before the earlier of the date of commencement of the road show, if any, or the anticipated date of effectiveness of the registration statement. In addition, the acquirer must make the required filings under Securities Act Rule 425 (unless it is relying on the Securities Act section 5(d) provision for test-the-waters communications) and Exchange Act Rule 14a-12(b) for any soliciting material, as applicable.⁶

Financial statement requirements

The SEC has stated that if a target company which does not qualify as a "smaller reporting company" is to be acquired by an EGC that is not a shell company and will

present only two years of its financial statements in its registration statement for the exchange offer or merger, the SEC will not object if, in the registration statement filed for the merger or exchange offer, the EGC presents only two years of financial statements for the target company.⁷

Spin-offs

The SEC has also addressed the EGC status of an issuer in the context of spin-offs and similar transactions. In circumstances where a public parent issuer decides to spin-off a wholly-owned subsidiary, register an offer and sale of the wholly-owned subsidiary's common stock for an initial public offering, or transfer a business into a newly-formed subsidiary for purposes of undertaking an initial public offering of that subsidiary's common stock, the subsidiary would not necessarily trigger any of the disqualification provisions in sections 2(a)(19)(A)-(D) of the Securities Act, and would thus be considered an EGC if it had less than \$1 billion in revenues during its most recently completed fiscal year.⁸ This analysis is focused on whether the issuer, and not its parent, meets the EGC requirements. The SEC notes that, based on the particular facts and circumstances, the EGC status of an issuer under these circumstances may be questioned if it appears that the issuer or its parent is engaging in a transaction for the purpose of converting a non-EGC into an EGC, or for the purpose of obtaining the benefits of EGC status indirectly when it is not entitled to do so directly. The SEC recommends that issuers with questions relating to these issues should contact the Division of Corporation Finance's Office of the Chief Counsel.

ENDNOTES

1. See Frequently Asked Questions of General Applicability on Title I of the JOBS Act (April 16 2012; May 3 2012 and September 28 2012), *available at* <http://www.sec.gov/divisions/corpfin/guidance/cfjjobstactfaq-title-i-general.htm> (SEC Title I FAQs).
2. JOBS Act §105(c), amending Securities Act § 5, 15 USC 77e.
3. SEC Title I FAQs, *supra* note 1, at Question 42.
4. For this purpose, the term “road show” is defined in Securities Act Rule 433(h)(4).
5. SEC Title I FAQs, *supra* note 1, at Question 43.
6. SEC Title I FAQs, *supra* note 1, at Question 44.
7. SEC Title I FAQs, *supra* note 1, at Question 45.
8. SEC Title I FAQs, *supra* note 1, at Question 53.

CHAPTER 4

Private offerings

Title II of the JOBS Act directs the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D under the Securities Act (Rule 506), provided that the securities are sold only to accredited investors, and offerings under Rule 144A under the Securities Act (Rule 144A), provided that the securities are sold only to persons who the seller (or someone acting on the seller's behalf) reasonably believes is a QIB.

Rule 506 is the most popular means for conducting a private offering, because it permits issuers to raise an unlimited amount of money and pre-empts state securities laws. In recognition of concerns about restrictions on communications in private offerings, Title II of the JOBS Act directs the SEC to revise Rule 506 to provide that the prohibition against general solicitation or general advertising in Rule 502(c) of Regulation D shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors, and to require that issuers using general solicitation or general advertising in connection with Rule 506 offerings take reasonable steps to verify that purchasers of securities are accredited investors, using methods to be determined by the SEC. Under the SEC's existing definition, an accredited investor is a person who falls within one of the categories specified in the definition, or a person who the issuer reasonably believes falls within one of those categories. With respect to Rule 144A, Title II of the JOBS Act directs the SEC to revise the rule to provide that securities may be offered to persons other than QIBs, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller (or someone acting on the seller's behalf) reasonably believes is a QIB. The JOBS Act specifies that any offering made pursuant to Rule 506 that uses general advertising or general solicitation will not be deemed a public offering.

Title II of the JOBS Act also specifies that persons who maintain certain online or other platforms to conduct Rule 506 offerings that will use general advertising or general solicitation will not, by virtue of this activity, be required to register as a broker or a dealer pursuant to Exchange Act

section 15, provided that enumerated conditions are satisfied. In order to qualify for this exemption, such a platform must not receive transaction-based compensation, take possession of customer funds or securities, or be subject to an Exchange Act statutory disqualification.

On July 10 2013, the SEC adopted final rules as directed by Title II of the JOBS Act to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 and offerings under Rule 144A, which we describe below.

Rule 506 of Regulation D

Rule 506 is considered a safe harbour for the private offering exemption of section 4(a)(2) of the Securities Act. Rule 506 has proven to be an attractive means for conducting private offerings, because an issuer using it can raise an unlimited amount of money. Prior to the adoption of the SEC's final rules, the conditions for using Rule 506 were as follows:

- The issuer cannot use general solicitation or advertising to market the securities;
- The issuer may sell its securities to an unlimited number of "accredited investors" and up to 35 other purchasers. Unlike Rule 505 of Regulation D (Rule 505), all non-accredited investors, either alone or with a purchaser representative, must be sophisticated: they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;
- An issuer must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws, with non-accredited investors receiving disclosure documents that are generally the same as those used in registered offerings, and if the issuer provides information to accredited investors, it must make this information available to non-accredited investors as well;
- The company must be available to answer questions from prospective purchasers;

- Financial statement requirements are the same as for Rule 505; and
- Purchasers receive “restricted securities.”

Issuers making use of the Rule 506 exemption do not have to file a registration statement with the SEC, but they must file a Form D after they first sell their securities. Form D is a brief notice that includes the names and addresses of the issuer’s owners and promoters and information concerning the offering.

For the purposes of Regulation D, an “accredited investor” includes:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- a charitable organisation, corporation, or partnership with assets exceeding \$5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person;
- a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
- a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

Prior to the adoption of the SEC’s final rules, Rule 506 did not include any bad actor limitations with respect to the issuer, its affiliates and offering participants, which were mandated pursuant to section 926 of the Dodd-Frank Act. We describe the bad actor limitations adopted by the SEC below.

Rule 144A

Rule 144A is a safe harbour exemption from the registration requirements of section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. Prior to the adoption of the SEC’s final rules, the exemption applied to re-offers and re-sales of securities to QIBs. The

securities eligible for resale under Rule 144A are securities of US and foreign issuers that are not listed on a US securities exchange or quoted on a US automated inter-dealer quotation system. Prior to the adoption of the SEC’s final rules, Rule 144A also provided that re-offers and re-sales in compliance with the rule are not distributions and that the reseller is therefore not an underwriter within the meaning of section 2(a)(11) of the Securities Act. A reseller that is not the issuer, an underwriter, or a dealer can rely on the exemption provided by section 4(a)(1) of the Securities Act. Resellers that are dealers can rely on the exemption provided by section 4(a)(3) of the Securities Act.

SEC rulemaking under Title II of the JOBS Act

Discussion related to relaxing the ban on general solicitation has been going on since the early 1990s. Speeches and statements by SEC staff members over the years have commented on, and acknowledged, the need to revisit private placement exemptions in light of changes in communications patterns. The legal community also has given close consideration to these questions, going as far back as the late 1990s and early 2000s. In 2001, the American Bar Association’s Committee on the Federal Regulation of Securities submitted a comment letter to the SEC that suggested relaxation of the ban on general solicitation. At around the same time, the American Bar Association’s Task Force for the Review of the Federal Securities Laws also proposed that a private offering would qualify for an exemption from registration based on the eligibility of the purchasers of the securities and the restrictions on re-sales, and not on the number of offerees. The Advisory Committee on Smaller Public Companies, formed in 2004, advocated a relaxation of the ban on general solicitation. In 2007, the SEC proposed a relaxation of the ban on general solicitation in the context of private offerings to a new category of “large accredited investors.”¹ On August 29 2012, the SEC issued proposed rules amending Rule 506 and Rule 144A to implement section 201(a) of the JOBS Act.² On July 10 2013, the SEC issued final rules amending Rule 506 and Rule 144A;³ and the final rules became effective on September 23 2013.

Final rules eliminating the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings

The final rules eliminate the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D with respect to offers and sales of securities made pursuant to Rule 506, provided that all purchasers are accredited investors. The final rules require

that for offerings involving the use of general solicitation, issuers take reasonable steps to verify that the purchasers of the securities are accredited investors. The final rules also provide that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, provided that the securities are sold only to purchasers that the seller (or someone acting on the seller's behalf) reasonably believes is a qualified institutional buyer. The SEC staff also has issued guidance in the form of compliance and disclosure interpretations (CD&Is) relating to the Rule 506(c) and Rule 144A amendments.⁴

Eliminating the prohibition against general solicitation

The SEC's final rules implement a bifurcated approach to Rule 506 offerings. An issuer may still choose to conduct a private offering in reliance on Rule 506 without using general solicitation. Under new Rule 506(c), general solicitation and general advertising are permitted so long as:

- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;
- all purchasers of securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
- the conditions of Rules 501, 502(a) and 502(d) of Regulation D are satisfied.⁵

The SEC noted that the exemption applies only to offerings made pursuant to the safe harbour provided by Rule 506(c), and it does not apply to offerings relying on the Securities Act section 4(a)(2) exemption in general.⁶

The SEC also confirmed that the effect of section 201(b) of the JOBS Act is to permit privately offered funds (including private equity funds and hedge funds, among others) to make a general solicitation under amended Rule 506 without losing the ability to rely on the exclusions from the definition of an investment company available under section 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended (the Investment Company Act).⁷

Reasonable steps to verify accredited investor status

The SEC indicated in the final rules that "reasonable efforts" to verify investor status will be a fact-based objective determination based on the SEC's prior principles-based guidance. New Rule 506(c) does not mandate any specific procedure that issuers must follow to be assured that the steps they have taken to verify that the purchasers of their securities are accredited investors are

reasonable. In the adopting release, the SEC stated that "[w]hether the steps taken are 'reasonable' will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction."⁸ The SEC noted that "reasonable efforts" to verify investor status may differ depending on the facts and circumstances, and the SEC indicated that it may be appropriate to consider the nature of the purchaser, the nature and amount of information about the purchaser, and the nature of the offering, as follows:

- **The nature of the purchaser.** The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities.
- **The nature and amount of information about the purchaser.** Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa."⁹
- **The nature of the offering.** The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status: issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email. By contrast, less intrusive verification steps may be required to the extent that solicitations are directed at investors that are pre-screened by a reliable third party.

The SEC stated that these factors are interconnected, and the more indicia that are in evidence that an investor qualifies as an accredited investor, the fewer steps that the issuer must take to verify status. The SEC noted that issuers should retain adequate records to document the verification process.

In response to the concerns of many commenters on the proposed rules, in new Rule 506(c), the SEC added the four following specific non-exclusive methods of verifying accredited investor status for natural persons that will be deemed to meet the "reasonable steps to verify" requirement:

- A review of IRS forms for the two most recent years and a written representation regarding the individual's expectation of attaining the necessary income level for the current year;
- A review of bank statements, brokerage statements, statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports by independent third parties in order to assess assets, and a consumer

- report or credit report from at least one nationwide consumer reporting agency in order to assess liabilities;
- A written confirmation from a registered broker-dealer, a registered investment adviser, a licensed attorney or a certified public accountant that such person or entity has taken reasonable steps to verify that the person is an accredited investor within the prior three months and has determined that the person is an accredited investor; and
- With respect to any natural person who invested in an issuer's Rule 506(b) private placement as an accredited investor prior to the effective date of new Rule 506(c) and remains an investor of that issuer, for any Rule 506(c) offering conducted by the same issuer, an issuer can obtain a certification from the person at the time of sale in the new offering that he or she qualifies as an accredited investor.¹⁰

Because an issuer has the burden of demonstrating that its offering is entitled to an exemption from the Securities Act registration requirements, regardless of the steps an issuer takes to verify accredited investor status, the SEC stated that “it will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.”¹¹

The SEC has received inquiries asking whether the SEC staff would provide guidance, presumably on a case-by-case basis, confirming that a specified principles-based verification method constitutes “reasonable steps” for purposes of Rule 506(c).¹² The SEC has indicated that the notion of the SEC staff reviewing and approving specific verification methods seems somewhat contrary to the very purpose of a principles-based rule and will not provide any additional guidance.¹³ Further, the SEC has expressed the view that this is an area where issuers and other market participants have the flexibility to think about innovative approaches for complying with the verification requirement of Rule 506(c) and use the methods that best suit their needs, and the SEC will not be quick to second guess decisions that issuers and their advisers make in good faith that appear to be reasonable under the circumstances.¹⁴

Reasonable belief

The SEC confirmed the view that Congress did not intend to eliminate the existing “reasonable belief” standard in Rule 501(a) of Regulation D or for Rule 506 offerings. It confirmed that if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, provided the

issuer “took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor.”¹⁵

Form D amendments

The SEC also amended Form D to add a separate check box for issuers to indicate whether they are claiming an exemption under Rule 506(c).¹⁶ Meredith Cross, former director of the SEC's Division of Corporation Finance, noted at the open meeting for the proposed rules that it was the SEC staff's intention to form a multi-divisional task force to monitor these offerings as a means of gaining insight into market practices.

Final amendment to Rule 144A

As amended, Rule 144A(d)(1) only requires that securities sold in reliance on the rule be sold to a QIB, or to a person that the seller and any person acting on behalf of the seller reasonably believes is a QIB.¹⁷ The SEC also amended Rule 144A to eliminate references to offer and offeree.¹⁸ The SEC also noted that the general solicitation now permitted by Rule 144A will not affect the availability of the section 4(a)(2) exemption or Regulation S for the initial sale of securities by the issuer to the initial purchaser.¹⁹

The SEC also clarified that for ongoing Rule 144A offerings that commenced before the effective date of the new rules, offering participants will be entitled to conduct the portion of the offering following the effective date of the new rules using a general solicitation, without affecting the availability of Rule 144A for the portion of the offering that occurred prior to the effective date.²⁰

Integration with offshore offerings

The SEC addressed the interplay between concurrent offerings made outside the United States in reliance on Regulation S and inside the United States made in reliance on Rule 506 or Rule 144A where there is a general solicitation or general advertising. Of particular concern is the requirement in Regulation S that there be no directed selling efforts in the United States.

The SEC reaffirmed its position that an offshore offering conducted in compliance with Regulation S would not be integrated with a concurrent domestic unregistered offering that is conducted in compliance with Rule 506 or Rule 144A, even if there is a general solicitation or general advertising. This position is consistent with the SEC's views regarding integration of concurrent offshore offerings made in compliance with Regulation S and registered domestic offerings.

Disqualification of felons and other bad actors from Rule 506 offerings

On July 10 2013, the SEC adopted amendments to rules promulgated under Regulation D to implement section 926 of the Dodd-Frank Act.²¹ The amendments add “bad actor” disqualification requirements to Rule 506, which prohibit issuers and others, such as underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The amendments were originally proposed on May 25 2011.²² In light of concerns raised by investor and consumer advocates that the relaxation of the prohibition against general solicitation in certain Rule 506 offerings would lead to an increased incidence of fraud, the SEC took action on the bad actor provisions at the same time as it promulgated the final Rule 506 amendments. The final rules (collectively, the bad actor rule) became effective on September 23 2013.

The new disqualification provisions apply to all Rule 506 offerings, regardless of whether general solicitation is used. Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that would make the Rule 506 exemption unavailable for any securities offering in which certain “felons” or other “bad actors” are involved. The new provisions generally track those in section 926 of the Dodd-Frank Act and Rule 262 of Regulation A under the Securities Act (Regulation A). Since the final rule became effective, the SEC staff has provided additional guidance on various interpretative matters in various series of CDIs as discussed below. Although it was anticipated that the relaxation of the prohibition against general solicitation in certain Rule 506 offerings and Rule 144A offerings would have a significant effect on the exempt offering market, at least in the short-term, the bad actor disqualification provisions have had a more immediate impact on offering practices. Issuers and financial intermediaries have had to establish policies and procedures and revise documentation in order to address these provisions.

Covered persons

The disqualification provisions in Rule 506(d)(1) apply to the following “covered persons”:

- the issuer and any predecessor of the issuer;
- any affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer;
- any beneficial owner of 20% or more of any class of the

issuer’s outstanding voting equity securities, calculated on the basis of voting power;

- any promoter (as defined in Rule 405) connected with the issuer in any capacity at the time of the sale;
- any investment manager of an issuer that is a pooled investment fund;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities (a “compensated solicitor”);
- any general partner or managing member of any such investment manager or compensated solicitor; or
- any director, executive officer or other officer participating in the offering of any such investment manager or compensated solicitor or general partner or managing member of such investment manager or compensated solicitor.²³

In the case of financial intermediaries likely to be involved in a private placement under Rule 506, the SEC applied the current standards in Rule 505. Because Rule 505 transactions do not involve underwritten public offerings, but rather the use of compensated placement agents and finders, the term “underwriters” in Rule 262 of Regulation A is replaced with “any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers (compensated solicitors).”²⁴

Rule 506(d)(3) provides that the disqualification provisions do not apply to events relating to any affiliated issuer that occurred before the affiliation arose if the affiliated entity is not (i) in control of the issuer or (ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

Two key changes from the categories of covered persons discussed in the proposing release are the inclusion in Rule 506(d)(1) of “executive officers” (ie those performing policy-making functions) of the issuer and the compensated solicitor, instead of just “officer,” and a change to 20% from 10% shareholders of the issuer.

Disqualifying events

The final rule includes eight categories of disqualifying events. They are:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders (as defined in Rule 501(g) of Regulation D) of certain state regulators (such as securities, banking, and insurance) and federal regulators, including the US Commodity Futures Trading Commission (CFTC);
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and

- investment companies and their associated persons;
- Certain SEC cease and desist orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organisation (SRO);
- SEC stop orders and orders suspending a Regulation A exemption; and
- US Postal Service false representation orders.²⁵

A discussion of each of these categories appears below.

Criminal convictions. Rule 506(d)(1)(i) provides for disqualification if any covered person who has been convicted of any felony or misdemeanour in connection with the purchase or sale of any security, involving the making of any false filing with the SEC or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities. The rule includes a five-year look-back period for criminal convictions of issuers, their predecessors and affiliated issuers, and a ten-year look-back period for other covered persons.²⁶

Court injunctions and restraining orders. Similar to Rule 262 of Regulation A, Rule 506(d)(1)(ii) disqualifies any covered person from relying on the exemption for a sale of securities if such covered person is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging in or continuing any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of a false filing with the SEC or (iii) arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.²⁷

Final orders of certain regulators. Final orders of regulatory agencies or authorities are covered by Rule 506(d)(1)(iii). That section disqualifies any covered person who is subject to a final order of: a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations or credit unions; a state insurance commission (or an agency or an officer of a state performing like functions); an appropriate federal banking agency; the CFTC; or the National Credit Union Administration. The order must be final and:

- (A) at the time of such sale, bar the person from:
 - a. associating with an entity regulated by such commission, authority, agency or officer;
 - b. engaging in the business of securities, insurance or banking; and
 - c. engaging in savings association or credit union activities; or

- (B) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within ten years of such sale.

In a change from the proposing release, the rule also added CFTC final orders as disqualification triggers. In adding CFTC final orders, the SEC noted that the CFTC (rather than the SEC) has authority over investment managers of pooled investment funds that invest in commodities and certain derivative products. The SEC reasoned that, absent adding CFTC final orders as a disqualifying trigger, regulatory sanctions against those investment managers would not likely trigger disqualification.²⁸

Final orders. Rule 501(g) of Regulation D defines a “final order” as “a written directive or declaratory statement issued by a federal or state agency described in [Rule 506(d)(1)(iii)] under applicable statutory authority that provides for notice and an opportunity for a hearing, which constitutes a final disposition or action by that federal or state agency.”²⁹ The definition is based on the Finra definition.

Fraudulent, manipulative or deceptive conduct. Rule 506(d)(1)(iii)(B) provides that disqualification must result from final orders of the relevant regulators that are “based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct.” Despite the suggestions of commenters, the SEC did not define “fraudulent, manipulative or deceptive conduct,” did not exclude technical or administrative violations and did not limit Rule 506(d)(1)(iii) to matters involving scienter.³⁰

SEC disciplinary orders. Currently under Rule 262(b)(3), issuers and other covered persons that are subject to an SEC order entered pursuant to sections 15(b), 15B(a) or 15B(c) of the Exchange Act, or sections 203(e) or (f) of the Investment Advisers Act of 1940 (the Advisers Act), are disqualified from relying on the exemption available under Regulation A under the Securities Act. Under the cited provisions of the Exchange Act and the Advisers Act, the SEC has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limits on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

The SEC has historically required disqualification periods to run only for as long as an act is prohibited or required to be performed pursuant to an order. Therefore, censures are not disqualifying and a disqualification based on a suspension or limitation of activities expires when the

suspension or limitation expires. Rule 506(d)(1)(iv) codifies this position, but removes the reference to section 15B(a) of the Exchange Act. No look-back period was added to the rule.³¹

Certain SEC cease and desist orders. Although not required by section 926 of the Dodd-Frank Act, the Commission added an additional disqualification trigger, using its existing authority previously used to create bad actor provisions. Under Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the SEC entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a future violation of: (i) any scienter-based anti-fraud provision of the federal securities laws, including, without limitation section 17(a)(1) of the Securities Act, section 10(b) of the Exchange Act and Rule 10b-5 thereunder and section 206(1) of the Advisers Act, or any other rule or regulation thereunder; or (ii) section 5 of the Securities Act. Note that the disqualification provision for section 5 of the Securities Act does not require scienter, which is consistent with the strict liability standard imposed by section 5.³²

Suspension or expulsion from SRO membership or association with an SRO member. Rule 506(d)(1)(vi) disqualifies any covered person that is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO, for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. This provision does not include a look-back period.³³

SEC stop orders and orders suspending the Regulation A exemption. Rule 506(d)(1)(vii) imposes disqualification on an offering if a covered person has filed (as a registrant or issuer), or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the SEC that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.³⁴

US Postal Service false representation orders. The final disqualification provision is enumerated in Rule 506(d)(1)(viii), which disqualifies any covered person that is subject to a US Postal Service false representation order entered within five years preceding the sale of securities, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the US Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.³⁵

Reasonable care exception

Rule 506(d)(2)(iv) creates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. The reasonable care exception helps preserve the intended benefits of Rule 506 and avoids creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.³⁶

In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the issuer and the other offering participants. In such an inquiry, an issuer would need to consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry, whether other means used to obtain information about the covered persons is adequate, and whether investigating publicly available information is reasonable.³⁷

Transition issues

Although the look-back provisions of Rule 506(d) reach back to disqualifying events prior to the effectiveness of the rule, Rule 506(d)(2)(i) provides that disqualification will not arise as a result of triggering events that occurred prior to the date of the amendments. However, Rule 506(e) requires written disclosure to purchasers, at a reasonable time prior to the sale, of matters that would have triggered disqualification except that they occurred prior to the rule's effective date. This disclosure requirement applies to all Rule 506 offerings, regardless of whether purchasers are accredited investors. Failure to make such disclosures will not be an "insignificant deviation" within the meaning of Rule 508 of Regulation D; consequently, relief under that rule will not be available for such failure.³⁸

The SEC staff has provided additional guidance on the application of the rule through various CD&Is, including those issued on November 13 2013, December 4 2013, January 3 2014 and January 23 2014.³⁹

Proposed amendments

Regulation D and Form D

Also on July 10 2013, the SEC issued proposed rules for comment that would impose a number of investor protection measures in connection with Rule 506(c) offerings.⁴⁰ These include a proposed amendment to Rule 503 of Regulation D in order to implement additional compliance requirements relating to the filing of a Form D. In connection with a Rule 506(c) offering, an issuer

would be required to file a Form D not later than 15 calendar days from the commencement of general solicitation efforts. In addition, in order to provide the SEC with more information regarding these types of offerings, the issuer would be required to file a final amendment to the Form D within 30 days after the completion of such an offering. Along the same lines, in order to make additional information available to the SEC, the proposal would revise Form D in order to request additional information in the context of Rule 506(c) offerings. The SEC also proposed an amendment to Rule 507 of Regulation D in order to promote compliance with the Form D filing requirement by implementing certain disqualification provisions where the issuer and its affiliates failed to comply with Form D filing requirements. The SEC would have the authority to grant waivers upon a showing of good cause by the issuer. The proposal also included the introduction of a new Rule 509 of Regulation D, which would require an issuer engaging in a Rule 506(c) offering to include certain legends on any written general solicitation materials. The required legends would alert potential investors of the type of offering, that the offering is available only to certain investors, and that the offering may involve certain risks. The proposal also would require that for a temporary period of two years, issuers must file with the SEC any written solicitation materials. These materials would not be available to the public. The proposal also solicited comment on the definition of “accredited investor” and on whether there should be additional requirements relating to the communications used in general solicitation.

Private funds and Rule 156

The SEC proposed to require private funds making Rule 506(c) offerings to file written general solicitation materials with the SEC on a temporary basis. The SEC also proposed to amend Rule 156 under the Securities Act, the anti-fraud rule that applies to sales literature of registered investment companies. The rule amendments would apply the guidance to sales literature of private funds making general solicitations under Rule 506.

Rule 156 under the Securities Act prevents registered investment companies from using sales literature that is materially misleading in connection with the offer and sale of securities. The comment period for the proposed rules has closed, and it is not clear whether the proposed rules will be adopted, or if adopted, the form in which the SEC will adopt them.

Impact of Rule 506 amendments on broker-dealers, investment advisers, CPOs and CTAs

The amendments to Rule 506 will not only significantly affect issuers, they likely will have a significant impact on broker-dealers, investment advisers, commodity pool operators (CPOs) and commodity trading advisers (CTAs) as well. Registered broker-dealers often act as intermediaries that facilitate Rule 506 offerings, while investment advisers (including CPOs and CTAs) organise and sponsor pooled investment funds that conduct Rule 506 offerings in an issuer capacity. Broker-dealers, investment advisers, CPOs and CTAs will be affected directly or indirectly by the amendments to Rule 506 in several ways, which we describe below.

Bad actor rule

SEC disciplinary orders relating to broker-dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons will constitute disqualifying events under the bad actor rule. The scope of the bad actor rule has also been expanded by using the term “investment manager” rather than “investment adviser.” This is meant to ensure that control persons of pooled funds that deal in instruments other than securities, such as commodities, real estate and certain derivatives, are covered persons and subject to disqualification under the bad actor rule. This revision recognised that, unlike operating companies making Rule 506 offerings, most pooled investment funds engaging in Rule 506 offerings function through their investment managers and their personnel and have few, if any, employees.

An issuer may rely on Rule 506’s exemption even if there is a disqualification as to a covered person, such as a broker-dealer, if the issuer can demonstrate that it did not know and, in the exercise of reasonable care, it could not have known about the disqualification at the time of the sale of securities. Although issuers are generally required to exercise that reasonable care and conduct associated factual inquiries themselves, when a registered broker-dealer acts as placement agent, it may be sufficient for the issuer to make inquiries concerning the relevant set of covered officers and controlling persons, and to consult publicly available databases concerning the past disciplinary history of the relevant persons. Broker-dealers are already required to obtain much of this information for their own compliance purposes, and the SEC anticipates that financial intermediaries and other market participants will develop procedures for assisting issuers in gathering the information necessary to satisfy the issuer’s factual inquiry requirement.

Use of general solicitation

Existing Finra rules governing offering-related communications take on greater significance with the wider availability of general solicitation in private placements. This includes Finra Rule 5123 (requiring Finra members selling securities issued by non-members in a private placement to file the private placement memorandum, term sheet or other offering documents with Finra within 15 days of the date of the first sale of securities) and Finra Rule 2210 (establishing pre-approval, filing, content and record retention requirements with respect to communications with retail investors). Furthermore, both broker-dealers and investment advisers participating in offerings in conjunction with issuers relying on Rule 506(c) will continue to be subject to Finra or SEC rules generally prohibiting false or untrue statements. Broker-dealers participating in offerings in conjunction with issuers relying on Rule 506(c) would continue to be subject to Finra rules regarding communications with the public, which, among other things: (1) generally require all member communications to be based on principles of fair dealing and good faith, to be fair and balanced and to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service; and (2) prohibit broker-dealers from making false, exaggerated, unwarranted, promissory or misleading statements or claims in any communications. As a result, it may be difficult to advertise effectively while still complying with these Finra rules.

In addition, while commodity pool operators (CPOs) are generally required to register with the Commodities Futures Trading Commission (CFTC) and comply with its rules, certain exemptions are available under CFTC Rules 4.7(b) and 4.13(a)(3) for CPOs who offer and accept investments only from accredited investors and other qualified persons without “marketing to the public.” Unless and until the CFTC acts to harmonise its rules, private funds relying on these regulations would not be able to take advantage of Rule 506(c). Similarly, commodity trading advisors (CTAs) that rely on the exemption contained in Section 4(m) of the Commodity Exchange Act, which is conditioned upon them not holding themselves out the public as a CTA and upon their providing trading advice to no more than 15 persons, would not be able to take advantage of Rule 506(c).

Finally, broker-dealers and investment companies will qualify as accredited investors under Rule 506(c).

Investor verification

An issuer may verify that its investors are accredited by, among other ways, obtaining written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that such person or entity has taken reasonable steps within the prior three months to verify that the purchaser is an accredited investor and has determined that such purchaser is an accredited investor. The rationale behind this provision is that these third parties are all subject to various other regulatory, licensing and examination requirements.

Matchmaking sites

Matchmaking sites have come to play a more significant role in capital formation in recent years. A matchmaking site generally relies on the internet in order to “match” or introduce potential investors to companies that may be interested in raising capital. However, in order to avoid the requirement to register as a broker-dealer, a matchmaking site will limit the scope of its activities. Under section 3(a)(4) of the Exchange Act, a “broker” is defined as any person that is “engaged in the business of effecting transactions in securities for the account of others.” The SEC has noted that a person “effects transactions in securities if he or she participates in such transactions ‘at key points in the chain of distribution,’” and that a person is “engaged in the business” if he or she receives transaction-related compensation, holds himself out “as a broker, as executing trades, or as assisting others in completing securities transactions.”⁴¹ The determination as to whether an entity is acting as a “broker” is complex. The SEC closely considers many criteria and the specific facts and circumstances. Generally, though, the SEC has attributed great significance to whether the person receives transaction-based compensation. Given that acting as an unregistered broker-dealer would be met with serious consequences, many matchmaking sites sought further SEC guidance. Prior to the enactment of the JOBS Act, the SEC staff issued several no-action letters to matchmaking sites that sought relief from the requirement to register as broker-dealers. The no-action letter relief generally was conditioned on the requirement that the matchmaking site: (1) not provide any advice, endorsement, analysis or recommendation about the merits of securities; (2) not receive compensation that is contingent on the outcome or completion of any securities transaction (“transaction-based compensation”); (3) not participate in any negotiations related to securities transactions; (4) not have any role in effecting securities trades; (5) not receive, transfer or hold any investor funds or securities; and (6) not hold itself out as a broker-dealer.⁴²

Section 201(b) of the JOBS Act provides further legal certainty. Pursuant to this section, in the absence of other activities that would require registration, a matchmaking site is exempt from the requirement to register as a broker-dealer if in connection with Rule 506 offerings: (1) it does not receive compensation based on the purchase or sale of securities; (2) it does not handle customer funds or securities; and (3) it is not a “bad actor.”⁴³ A matchmaking site may maintain “a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means.” A matchmaking site also may provide “ancillary services” in connection with Rule 506 offerings, which include “due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors;” and “the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.” This provision applies only to the activities of matchmaking sites in Rule 506 offerings. Although many articles in the popular press refer to the use of the internet to offer securities in Rule 506 offerings to accredited investors as “crowdfunding” or “accredited investor crowdfunding,” it is important to note that the transactions taking place on such sites do not rely on the exemption under section 4(a)(6) of the Securities Act for crowd-funded offerings, and that the exemption from broker-dealer registration would not be available for crowd-funded offerings.⁴⁴ Crowd-funded offerings must be conducted by either a registered broker-dealer or a registered funding portal.

In order to provide additional guidance relating to matchmaking sites, the SEC staff issued guidance in the form of Frequently Asked Questions.⁴⁵ Also, in March 2013, the SEC’s Division of Trading and Markets provided the first no-action relief from registration as a broker-dealer after the issuance of the JOBS Act in a letter to FundersClub (“FundersClub”) and FundersClub Management (“FC Management”).⁴⁶ In the letter, the SEL indicated that the Division would not recommend enforcement action under section 15(a)(1) of the Exchange Act if FundersClub and FundersClub Management operated a platform through which its members could participate in Rule 506 offerings. FundersClub identifies start-up companies in which its

affiliated fund will invest, and then posts information about the start-up companies on its website so that the information is only available to FundersClub members, who are all accredited investors. The FundersClub members may submit non-binding indications of interest in an investment fund, which is relying on Rule 506 to conduct the offering. When a target level of capital is reached, the indication of interest process is closed and FundersClub reconfirms investors’ interest and accredited investor status, and negotiates the final terms of the investment fund’s investment in the start-up company. Members may withdraw their indications of interest at any time. In this process, FundersClub and FundersClub Management do not receive any compensation, however some administrative fees are charged. FundersClub and FundersClub Management intend to be compensated through their role in organizing and managing the investment funds (at a rate of 20% or less of the profits of the investment fund, but never exceeding 30%). The SEC staff notes in the no-action letter that FundersClub’s and FundersClub Management’s current activities appear to comply with section 201 of the JOBS Act, in part because they and each person associated with them receive no compensation (or the promise of future compensation) in connection with the purchase or sale of securities. However, once FundersClub, FundersClub Management or persons associated with them receive compensation or the promise of future compensation, as described in their incoming letter, they will no longer be able to rely on section 201 of the JOBS Act. The SEC staff issued similar no-action relief to AngelList.⁴⁷

These letters are narrowly focused, and do not address whether other registrations (such as registration as an investment adviser) would be required to be obtained. Also, the letters do not address or comment on any issues related to “general solicitation” or the means by which investors are identified or contacted. Given the popularity of matchmaking sites, an issuer may consider using such a service in connection with a proposed Rule 506 offering. The issuer and its counsel should familiarise itself with the business model and the operations of the matchmaking site. It will be essential for the issuer to understand whether the site is relying on the exemption under section 201 of the JOBS Act, or whether it is a registered broker-dealer, and the functions or services that the site will provide in connection with the financing. In addition, the issuer also will need to understand whether the activities of the site are organised in a manner that would constitute a “general solicitation,” requiring the issuer to rely on Rule 506(c) for its exemption and thereby triggering a need to conduct additional investor verification.

ENDNOTES

1. SEC Release No. 33-8828 (August 3 2007), *available at* <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>.
2. SEC Release No. 33-9354 (August 29 2012), *available at* <http://www.sec.gov/rules/proposed/2012/33-9354.pdf>.
3. SEC Release Nos. 33-9415 (July 10 2013), *available at* <http://www.sec.gov/rules/final/2013/33-9415.pdf>
4. *See* <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.
5. *Supra* note 3, at 20.
6. *Id.* at 12.
7. *Id.* at 47.
8. *Id.* at 20, 28-29.
9. *Id.* at 31.
10. *Id.* at 35.
11. *Id.* 28-29.
12. *See* speech of Keith F. Higgins, Director, Division of Corporation Finance, titled “Keynote Address at the 2014 Angel Capital Association Summit” (March 28 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541320533#.U2PsBBnD-Hs>.
13. *Id.*
14. *Id.*
15. *Id.* at 44.
16. *Id.* at 45.
17. *Id.* at 56.
18. *Id.* at 55.
19. *Id.*
20. *Id.* at 57.
21. SEC Release No. 33-9414 (July 10 2013), *available at* <http://www.sec.gov/rules/final/2013/33-9414.pdf>.
22. SEC Release No. 33-9211 (May 25 2011), *available at* <http://www.sec.gov/rules/proposed/2011/33-9211.pdf>.
23. *Supra* note 19, at 13.
24. *Id.* at 29.
25. *Id.* at 30.
26. *Id.* at 33.
27. *Id.* at 36.
28. *Id.* at 39.
29. *Id.* at 49.
30. *Id.*
31. *Id.* at 52.
32. *Id.* at 54.
33. *Id.* at 59.
34. *Id.* at 60.
35. *Id.* at 61.
36. Regulation D already has a provision, Rule 508, under which “insignificant deviations” from the terms, conditions, and requirements of Regulation D will not result in the loss of the exemption if the person relying on the exemption can show that: (i) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole; and (iii) a good faith and reasonable attempt was made to comply. The SEC does not believe that Rule 508 of Regulation D would cover circumstances in which an offering was disqualified under Rule 506(d).
37. *Supra* note 19, at 62.
38. *Id.* at 73.
39. *See* <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.
40. SEC Release Nos. 33-9416 (July 10 2013), *available at* <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>.
41. *See* SEC Denial of No-Action Request to Oil-N-Gas, Inc. (June 8 2000); SEC Denial of No-Action Request to Progressive Technology Inc. (October 11 2000); and SEC Denial of No-Action Request to 1st Global, Inc. (May 7 2001).
42. *See* Angel Capital Electronic Network, SEC No-Action Letter (October 25 1996); E-Media, LLC, SEC No-Action Letter (December 14 2000); Swiss American Securities, Inc. and Streetline, Inc., SEC No-Action Letter (May 28 2002); The Investment Archive, LLC, SEC No-Action Letter (May 14 2010); Roadshow Broadcast, LLC, SEC No-Action Letter (May 6 2011); and S3 Matching Technologies LP, SEC No-Action Letter (July 19 2012).
43. JOBS Act § 201(c)(2).

44. For more information regarding crowdfunding offerings, *see* Chapter 5 (Crowdfunding).
45. *See* Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act, *available at* <http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm>.
46. *See* FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (March 26 2013).
47. *See* AngelList LLC, SEC No-Action Letter (March 28 2013).

CHAPTER 5

Crowdfunding

Title III of the JOBS Act addresses crowdfunding, an outgrowth of social media that provides an emerging source of funding for a variety of ventures. Crowdfunding works based on the ability to pool money from individuals who have a common interest and are willing to provide small contributions for a venture. Given the difficulty in relying on existing exemptions from registration for crowdfunding efforts involving the offer and sale of securities, Title III of JOBS Act amended section 4(a) of the Securities Act to add a new paragraph (6), which provides for a new crowdfunding exemption from SEC registration (subject to rulemaking by the SEC), as well as pre-emption from state Blue Sky laws.

Crowdfunding can be used to accomplish a variety of goals (such as raising money for a charity or other causes of interest to the participants), but when the goal is of a commercial nature and there is an opportunity for crowdfunding participants to participate in the venture's profits, it is likely that federal and state securities laws will apply. Absent an exemption from registration with the SEC, or registering the offering with the SEC, crowdfunding efforts that involve the offer and sale of securities are in all likelihood illegal. In addition to SEC requirements, those seeking capital through crowdfunding need to be aware of state securities laws, which include varying requirements and exemptions. By crowdfunding through the internet, a person or venture can be exposed to potential liability at the US federal level, in all fifty states, and potentially in foreign jurisdictions.

Existing exemptions present some problems for persons seeking to raise capital through crowdfunding. Regulation A requires a filing with the SEC and disclosure in the form of an offering circular, which would make conducting a crowdfunding offering difficult. The Regulation D exemptions generally would prove too cumbersome (with the possible exception of Rule 504), and a private offering approach or the intrastate offering exemption is inconsistent with widespread use of the internet for crowdfunding.

The potential illegality of crowdfunding efforts involving the offer and sale of securities was demonstrated

in the SEC enforcement action *In the matter of Michael Migliozi II and Brian William Flatow*,¹ which the SEC brought against two individuals in connection with their efforts to allegedly raise small contributions using the internet in order to purchase Pabst Brewing Company for \$300 million. Migliozi and Flatow settled the proceeding, consenting to a cease and desist order relating to the alleged violation of the registration provisions of the Securities Act. The order indicates that Migliozi and Flatow established the BuyBeerCompany.com website, and then used Facebook and Twitter to advertise the website. They sought pledges from participants in the crowdfunding effort, and in return participants were told that if the \$300 million necessary to purchase Pabst was raised, the participants would receive a “crowdsourced certificate of ownership” as well as an amount of beer of a value equal to the money invested. While no monies were ever collected from the crowdfunding participants who made the pledges, the SEC alleged that Migliozi and Flatow nonetheless violated the registration provisions of the federal securities laws by offering the security (in this case, the crowdsourced certificate of ownership) without registering the offer with the SEC or having an exemption, such as the private placement exemption, available for the offer.

In recent years, crowdfunding advocates have requested that the SEC consider implementing an exemption from registration under the federal securities laws for crowdfunding efforts. For example, a rulemaking petition submitted by the Sustainable Economics Law Center suggested that the SEC exempt crowdfunding offerings of up to \$100,000, with a cap on individual investments not to exceed \$100.² Also, following a recent SEC Forum on Small Business Capital Formation, the Small Business & Entrepreneurship Council submitted comments suggesting that the SEC adopt a small business offering exemption for offerings of less than \$1 million with a limit on the amount any one individual could contribute to no more than 10% of the previous year's stated income of the issuer or up to \$10,000 per individual. Before enactment of Title III of the JOBS Act, the SEC was considering whether to implement an exemption for crowdfunding, in

addition to a variety of other measures to encourage capital formation.

When HR 3606 was originally adopted in the House of Representatives, the bill included Title III, titled Entrepreneur Access to Capital. This Title provided for an exemption from registration under the Securities Act for offerings of up to \$1 million, or \$2 million in certain cases when investors were provided with audited financial statements, provided that individual investments were limited to \$10,000 or 10% of the investor's annual income. The exemption was conditioned on issuers and intermediaries meeting a number of specific requirements, including notice to the SEC about the offering and the parties involved with the offering, which would be shared with state regulatory authorities. The measure would have permitted an unlimited number of investors in the crowdfunding offering, and would have pre-empted state securities regulation of these types of offerings (except that states would be permitted to address fraudulent offerings through their existing enforcement mechanisms). The House measure also contemplated that the issuer would state a target offering amount and a third-party custodian would withhold the proceeds of the offering until the issuer has raised 60% of the target offering amount. The provision also contemplated certain disclosures and questions for investors, and provided for an exemption from broker-dealer registration for intermediaries involved in an exempt crowdfunding offering.

After it was adopted, the House crowdfunding measure drew a significant amount of criticism, with much of that criticism focused on a perceived lack of investor protections. In a letter to the Senate leadership, then-SEC chairman Mary Schapiro noted that "an important safeguard that could be considered to better protect investors in crowdfunding offerings would be to provide for oversight of industry professionals that intermediate and facilitate these offerings," and also noted that additional information about companies seeking to raise capital through crowdfunding offerings would benefit investors.

In the Senate, an amendment to HR 3606 that was submitted by Senator Merkley and approved by the Senate provided additional investor protections for exempt crowdfunding offerings. Many of these protections may now present difficulties as the SEC and market participants seek to make use of the JOBS Act crowdfunding exemption.

Title III of the JOBS Act

Title III of the JOBS Act addresses crowdfunding by providing an exemption from registration provided that:

- the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is not more than \$1 million;
- the aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed:
 - the greater of \$2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000, or
 - 10% of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000;
- the transaction is conducted through a registered broker or funding portal that complies with the requirements of the exemption; and
- the issuer complies with a number of specific informational and other requirements specified under the exemption.

Title III specified that the SEC must issue rules to implement this provision not later than 270 days following enactment. On October 23 2013, the SEC issued proposed rules to implement the crowdfunding exemption, which we discuss below. However, until final rules are adopted, the crowdfunding exemption contemplated by Securities Act section 4(a)(6) is not available.

Requirements as to intermediaries

An exempt crowdfunding offering must be made through an intermediary that has registered with the SEC as a broker or as a so-called funding portal. Funding portals will not be subject to registration as a broker-dealer, but would be subject to an alternative regulatory regime with oversight by the SEC and the Financial Industry Regulatory Authority (Finra), to be determined by rulemaking at the SEC and Finra. A funding portal is defined as an intermediary for exempt crowdfunding offerings that does not:

- offer investment advice or recommendations;
- solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal;
- compensate employees, agents, or other persons for

such solicitation, or based on the sale of securities displayed or referenced on its website or portal;

- hold, manage, possess, or otherwise handle investor funds or securities; or
- engage in other activities as the SEC may determine by rulemaking.

A crowdfunding intermediary must provide specified disclosures to investors and take other steps related to the offering oriented toward investor protection, such as:

- ensuring that all offering proceeds are only provided to issuers when the amount equals or exceeds the target offering amount, and allowing for cancellation of commitments to purchase in the offering;
- ensuring that no investor in a 12-month period has invested in excess of the limit described above in all issuers conducting exempt crowdfunding offerings;
- taking steps to protect privacy of information;
- not compensating promoters, finders, or lead generators for providing personal identifying information of personal investors;
- prohibiting insiders from having any financial interest in an issuer using that intermediary's services; and
- meeting any other requirements that the SEC may prescribe.

Requirements as to issuers

Issuers also must meet specific conditions in order to rely on the exemption, including making filings with the SEC and providing to investors and intermediaries information about the issuer (including financial statements, which would be reviewed or audited depending on the size of the target offering amount), its officers, directors, and greater than 20% shareholders, and risks relating to the issuer and the offering, as well specific offering information such as the use of proceeds for the offering, the target amount for the offering, the deadline to reach the target offering amount, and regular updates regarding progress toward reaching the target. A crowdfunding issuer will also be subject to reporting requirements after the offering, as the SEC may determine pursuant to its rules. Securities sold in crowdfunding offerings are not restricted securities, but they are subject to transfer restrictions for one year following the sale.

The SEC's rules adopted under Title III will also prohibit issuers from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker, and will require disclosure of amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.

A purchaser in a crowdfunding offering could bring an action against an issuer for rescission in accordance with section 12(b) and section 13 of the Securities Act, as if liability were created under section 12(a)(2) of the Securities Act, in the event that there are material misstatements or omissions in connection with the offering.

The crowdfunding exemption is only available for domestic issuers that are not reporting companies under the Exchange Act and that are not investment companies, or as the SEC otherwise determines is appropriate. Bad actor disqualification provisions similar to those required under Regulation A are also required for exempt crowdfunding offerings.

The Title III exemption pre-empts state securities laws by making exempt crowdfunding securities "covered securities"; however, some state enforcement authority and notice filing requirements would be retained. State regulation of funding portals will also be pre-empted, subject to limited enforcement and examination authority.

Proposed rules

On October 23 2013, the SEC issued its proposed rulemaking, referred to as Regulation Crowdfunding, to implement the crowdfunding exemption.³ Regulation Crowdfunding consists of five subparts totaling 20 individual rules under a new section 4(a)(6) of the Securities Act (section 4(a)(6)). The proposal acknowledges that regulation of these offerings requires adapting disclosure-based principles and the existing approach to broker-dealer regulation and oversight to an entirely new public offering rubric.

The ability to engage in crowdfunding is not available to all issuers. Proposed Rule 100(b) expands the list of ineligible issuers by, for example, excluding foreign issuers and issuers subject to 'bad boy' disqualifications.⁴ Proposed Rule 100(a)(3) provides that an issuer may engage in a crowdfunding offering only through a registered broker-dealer or through a funding portal, and can only use one intermediary for a particular offering or concurrent offerings made in reliance on the exemption. A 'platform' is defined as an Internet website or similar electronic medium through which a broker-dealer or a funding portal conducts an offering under new section 4(a)(6).⁵ The proposed rules set out a regulatory framework for these intermediaries. In the case of funding portals, the regulatory framework is a scaled back version of the framework applicable to broker-dealers. The proposed rules extend in significant ways the duties of intermediaries in crowdfunded offerings. The proposed rules would impose various requirements on intermediaries, including,

for funding portals, modified registration requirements, compliance and recordkeeping requirements, investor education obligations, limitations on the permitted activities and compensation of an intermediary, and obligations relating to the mechanics of an offering.

The proposed rules also set out rules that would be applicable to issuers, including a three-part disclosure obligation. An issuer must file required disclosures under EDGAR, must provide the required disclosures to investors and the relevant intermediary, and must make the required disclosures available to potential investors.⁶ Form C is used for the required initial disclosure about the offering; amendments to Form C to report material changes on Form C-A; periodic updates on the offering on Form C-U; and ongoing annual filings until a filing obligation is terminated. The annual filing must be made on Form C-AR and a termination notice on Form C-TR. The Form C would be filed with the SEC and the intermediary could post the filing or provide a link to the filing for investors. Once an issuer completes a crowdfunded offering, it becomes subject to limited ongoing filing requirements. Annually, within 120 days of the end of the issuer's fiscal year, the issuer must prepare and file an annual report on Form C-AR. The annual report should update information included in the Form C. This reporting obligation continues until the issuer becomes a reporting company, all securities sold in crowdfunded offerings are redeemed or repurchased by a third party, or the issuer liquidates or dissolves.⁷

The comment period on the proposed rule closed on February 3 2014, but there is no certainty when the SEC will issue final rules.

SEC and Finra guidance

On May 7 2012, the SEC's Division of Trading and Markets issued frequently asked questions which addressed a number of questions regarding crowdfunding intermediaries under Title III of the JOBS Act.⁸ The SEC's answers described the various provisions of Title III applicable to crowdfunding intermediaries that are outlined above.

Finra has established an interim form to seek information from prospective funding portals intending to apply for membership with Finra pursuant to Title III of the JOBS Act. Finra has invited prospective funding portals to complete the Interim Form for Funding Portals (IFFP) voluntarily until Finra and the SEC adopt final rules implementing Title III of the JOBS Act and establishing the registration procedures for funding portals.⁹

Until the SEC and Finra rules are adopted, Finra will use the information collected with the IFFP to become more familiar with the proposed business models, activities and operations of funding portals. Once the final crowdfunding rules are adopted, additional information will be required of funding portals seeking to actually register with Finra and the SEC. The information Finra now requests includes:

- contact and general information about the funding portal;
- ownership and funding information about the prospective funding portal;
- information about the prospective funding portal's management; and
- information about the funding portal's business relationships, business model and compensation.

Finra will treat information submitted using the IFFP as confidential.

Proposed Finra rules

As discussed above, intermediaries must be registered with Finra. On October 23 2013, Finra issued seven proposed rules (Rules 100, 110, 200, 300, 800, 900 and 1200), referred to as the Funding Portal Rules.¹⁰ The proposed rules reflect an attempt to streamline regulatory requirements in light of the limited scope of activities of a funding portal, while maintaining investor protection provisions. Below is a brief description of the proposed rules.

- Rule 100 would subject funding portals and their associated persons to Finra's bylaws.
- Rule 110 would outline the membership application process (MAP), which is based on the NASD's Rule 1010 Series but is abridged. Finra must make a decision on membership within 60 days of the filing of a membership application (Form FP-NMA). Rule 110 would establish five standards for membership: (a) ability to comply with all applicable laws and regulations of the SEC and Finra; (b) contractual arrangements sufficient to initiate operations; (c) supervisory systems that are sufficient; (d) evidence of direct and indirect funding; and (e) a recordkeeping system. Rule 110 also would permit membership interviews to take place by video, streamline the appeals process and narrow the events involving a change of control of the member that require Finra approval. Rule 110 also sets out a fidelity bond requirement.
- Rule 200(a) would require funding portals to observe high standards of commercial honour and just and equitable principles of trade. Rule 200(b) would prohibit a portal from effecting any transaction in, or

inducing the purchase or sale of, any security by means of, or by aiding or abetting, any manipulative or fraudulent device. Rule 200(c) tracks Finra Rule 2210 on advertising and requires that funding portal communications be fair and balanced, and would prohibit the use of false and misleading statements and statements that predict future performance.

- Rule 300 would require funding portals to: establish written policies and procedures and supervisory systems reasonably designed to achieve compliance with all applicable rules; implement an anti-money laundering (AML) programme, although the independent testing requirements have been reduced (compared to those for broker-dealers) to once every two years; timely report to Finra the occurrence of a disqualifying event affecting the member or an associated person; and report current contact information.
- Rule 800 would provide that information about funding portals and associated persons provided to Finra, including information about disqualifying events, will be made public.
- Rule 900 addresses codes of procedure, including the process for eligibility proceedings for a person to remain associated with a portal despite the existence of a statutory disqualification.
- Rule 1200 addresses arbitration procedures for customer and industry disputes.

The comment period on the proposed rules closed on February 3 2014, but there is no certainty when Finra will issue final rules.

Appendix A INTERMEDIARY COMPARISON		
	Broker-dealer	Funding portal
Regulatory environment	Well-established SEC and Finra rules regarding registration and ongoing obligations.	To be established SEC and Finra rules regarding registration and ongoing obligations.
Conduct of business	Handling customer funds and securities, making investment recommendations, compensated for sales of securities, etc.	Restrictions on activities traditionally considered to be those activities characteristic of broker-dealer status.
Costs	Significant registration costs, as well as ongoing compliance costs.	Expected to be less burdensome ongoing obligations, thus lower costs involved.
Availability of crowdfunding exemption	Available for issuers using broker-dealer's platform.	Available for issuers using funding portal's platform.

ENDNOTES

1. SEC Release No. 33-9216 (June 8 2011).
2. Sustainable Economies Law Center, Petition for Rulemaking, Petition No. 4 -605, *available at* <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>.
3. SEC Release No. 33-9470 (October 23 2013).
4. Proposed Rule 503(c).
5. Proposed Rule 100(d).
6. Proposed Rule 201.
7. Proposed Rules 202 and 203(b).
8. Frequently Asked Questions About Crowdfunding Intermediaries (May 17 2012), *available at* <http://www.sec.gov/divisions/marketreg/tmjbsact-crowdfundingintermediariesfaq.htm>.
9. The IFFP is *available at* <http://www.finra.org/Industry/Issues/Crowdfunding/>.
10. Finra Regulatory Notice 13-34 (October 2013).

CHAPTER 6

Regulation A+

As we discuss in Chapter 4, most issuers rely on exemptions from registration adopted pursuant to section 4 of the Securities Act to raise capital. There are, however, a number of other exemptions from registration that may be available to issuers. Section 3(b) of the Securities Act authorises the SEC to adopt rules and regulations exempting securities from registration if the SEC finds that registration “is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering...” One of the exemptions that the SEC adopted pursuant to section 3(b) of the Securities Act is Regulation A.¹ Pursuant to Regulation A, issuers that are not SEC-reporting companies may raise up to \$5 million through sales of their securities in interstate offerings without complying with the registration requirements of the Securities Act.² Regulation A also provides controlling stockholders, as well as non-affiliates, an opportunity to sell their unregistered securities. A Regulation A offering is not a private offering. In fact, it is often referred to as a mini-registration. Regulation A incorporates a number of conditions that in certain respects resemble the registration requirements of section 5 of the Securities Act. For example, in order for an issuer to avail itself of the Regulation A exemption, it must:

- prepare and file with the SEC an offering statement for the SEC’s review and approval;
- deliver the offering statement to prospective investors; and
- file periodic reports of sales after completion of the offering.

The requirements for the offering statement are not as onerous as those applicable to a section 10 prospectus, and the issuer is not subject to section 11 liability in respect of the offering statement.

Due to the low offering threshold, and without a corresponding state blue sky exemption for securities offered in Regulation A offerings, Regulation A has not provided a viable capital-raising vehicle for smaller companies in recent years, and Rule 506 of Regulation D, which has no offering threshold, has become the most commonly used exemption from registration.

Regulation A reform has been considered at various times in recent years, but it was not until 2011 and 2012 that legislative efforts to amend the exemption took shape. As discussed below, these legislative proposals, if passed, would have raised the offering threshold and modernised existing Regulation A. Ultimately, however, many of these concepts were incorporated into Title IV of the JOBS Act, titled Small Company Capital Formation. Title IV of the JOBS Act amends section 3(b) of the Securities Act, increasing the dollar threshold for a Regulation A-style offering, but does not actually amend existing Regulation A. Below we provide an overview of current Regulation A as it is likely that this existing framework will be incorporated into the new section 3(b)(2) offering exemption, as well as the SEC’s proposed rules to retain and modernise this framework.

Regulation A

Regulation A was enacted during the Great Depression to promote capital formation for small businesses. One of the SEC’s primary purposes in adopting Regulation A was to provide a simple and efficient process by which small businesses could raise limited amounts of capital, while ensuring that investors had access to current information. When originally enacted, section 3(b) authorised the SEC to exempt only “small” issues involving offerings of \$100,000 or less. Over time, this dollar threshold was adjusted. In 1980, the small issue exemption was increased by Congress to \$5 million.³ The SEC did not actually increase the threshold until 1992, however.⁴ In 1992, the US economic downturn⁵ provided the necessary backdrop for the SEC to modernise Regulation A in order to promote small business capital formation.⁶ Reinventing small business was linked to creating job opportunities and spurring economic growth.⁷ In July 1992, the SEC adopted a number of small business-related initiatives that included significant amendments to Regulation A.⁸ These changes were intended to facilitate “access to the public market for start-up and developing companies and ... [to reduce] the costs for small businesses to undertake to have their securities traded in the public markets.”⁹ The amendments increased the threshold amount to \$5 million

in any 12-month period, including no more than \$1.5 million in non-issuer resales. Also, the amendments permitted issuers to use a simplified disclosure document and to test the waters before preparing the mandated offering circular. The SEC also extended the safe harbour provisions for forward-looking statements to statements made in a Regulation A offering circular or any written material submitted to the SEC. Finally, the SEC clarified that an issuer would not be precluded from relying on the exemption if it had endeavoured in good faith to comply with the terms, conditions, and requirements of Regulation A.

Regulation A requirements

The availability of Regulation A is conditioned upon meeting certain substantive and procedural requirements.¹⁰ The principal requirement relates to the dollar size of the offering. If that requirement is met, the issuer must file the appropriate forms with the SEC. Failure to comply with either the dollar limit or the filing requirements results in the loss of the exemption and a violation of section 5 of the Securities Act.

Eligible issuers

The Regulation A exemption is available for any US or Canadian entity that has its principal place of business in the United States or Canada¹¹ and is not subject to reporting obligations under section 13 or section 15(d) of the Exchange Act immediately before the offering.¹² The following issuers are ineligible to offer or sell securities under Regulation A:

- (i) any issuer that is a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies;¹³
- (ii) any investment company registered or required to be registered under the Investment Company Act of 1940;¹⁴ and
- (iii) any entity issuing fractional undivided interests in oil or gas rights, or similar interest in other mineral rights.¹⁵

Rule 262 of Regulation A also contains certain bad actor provisions, identifying specific types of improper conduct undertaken by an issuer or certain affiliated parties that will disqualify the issuer from being able to avail itself of Regulation A.¹⁶

Offerings

Regulation A may be used by an issuer to conduct a primary offering of its securities with the proceeds to be used by the issuer, as well as to conduct a secondary offering of securities on behalf of selling security holders.¹⁷

There are a few limitations built into Rule 251(b) of Regulation A as it relates to secondary offerings of securities on behalf of selling security holders. First, no affiliate resales are permitted if the issuer has not had net income from continuing operations in at least one of its last two fiscal years. Second, Rule 251(b) maximises the offering amount to \$1.5 million offered by all selling security holders. Continuous or delayed offerings may be made pursuant to Regulation A if permitted by Rule 415 under the Securities Act.¹⁸ An offering circular for a continuous offering must be updated to include, among other things, updated financial statements, 12 months after the date the offering statement was qualified.¹⁹

Integration of offerings

Rule 251 of Regulation A provides for certain integration safe harbors. Rule 251(c) provides that offers or sales made in reliance on Regulation A will not be integrated with:

- (i) prior offers or sales of securities; or
- (ii) subsequent offers or sales of securities that are:
 - (a) registered under the Securities Act, except as provided in Rule 254(d) of Regulation A,
 - (b) made in reliance on Rule 701 under the Securities Act,
 - (c) made pursuant to an employee benefit plan,
 - (d) made in reliance on Regulation S, or
 - (e) made more than six months after the completion of the Regulation A offering.

Rule 251(c)(1) provides certainty from integration with respect to any prior offers or sales of securities. For example, an issuer could make a private offering under section 4(a)(2) or Regulation D before commencing a Regulation A offering without risking integration of the private offering with the Regulation A offering. For offerings made subsequent to the Regulation A offering, the Rule 251(c)(2) safe harbour period begins at the latest “six months after completion of the Regulation A offering;”²⁰ however, depending on how the offering is structured, as enumerated by Rule 251(c)(2)(i)–(iv), it may begin immediately subsequent to completion of the Regulation A offering. In addition, a note to Rule 251(c) provides that, if the integration safe harbour is unavailable, offers and sales still may not be integrated with a Regulation A offering, subject to the particular facts and circumstances. An issuer and its adviser may consider the traditional SEC five-factor integration test in analysing the offerings.

Offering disclosures

An issuer who seeks to rely on Regulation A must still file and qualify an offering statement.²¹ The offering statement

is intended to be a disclosure document that provides potential investors with information that will form the basis for their investment decision. In addition, in July 1992, as part of its Small Business Initiative, the SEC adopted significant amendments to Regulation A.²² These amendments imposed requirements for the offering circular, which had the effect of creating more similarities between an offering circular and a prospectus used in a registered offering. An offering circular is generally less detailed, however. Rule 253(a) of Regulation A provides that an offering circular must include the narrative and financial information required by Form 1-A.²³ Rule 252(a) of Regulation A also requires that “any other material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading” be included.

Part II of Form 1-A sets forth the specific information required to be disclosed and provides two formats for the offering circular: all corporate issuers may use Model A of Part II of Form 1-A and disclose the information required by the form; and all other issuers, and any issuer that so chooses (including corporate issuers), may use either Part I of Form S-1, except for the financial statements required by Form S-1, or Model B of Part II of Form 1-A.²⁴ Depending on the type of issuer, the required disclosure content must follow either Model A, which follows a question-and-answer format, or Model B, which is generally similar to an S-form registration statement, or Part I of Form S-1. Financial statements for the preceding two fiscal years must be filed as part of the offering statement and included in the offering circular under both models.²⁵ Unless an issuer has prepared audited financials for other purposes, the financial statements to be filed under Regulation A need not be audited.²⁶ The financial statements must be prepared in accordance with generally accepted accounting principles (GAAP) in the United States. Regulation A filings are not currently made via EDGAR.

Liability

An exempt offering pursuant to Regulation A is excluded from the operation of section 11 of the Securities Act. Regulation A offerings are, however, subject to the antifraud provisions under the federal securities laws.

Offering communications

An issuer engaged in a Regulation A offering has substantial flexibility regarding offering communications. No sale of securities can be completed without the use of an offering circular; however, an issuer may solicit retail investors, including investors that are not accredited

investors. In addition, an issuer may test the waters before preparing and filing offering materials. This is an important advantage associated with a Regulation A offering. In the pre-filing period, before the issuer files an offering statement, Rule 254(a) of Regulation A allows an issuer to publish or deliver to prospective purchasers a written document or to make scripted radio or television broadcasts to determine whether there is interest in a contemplated securities offering.²⁷ An issuer must comply with specified requirements in connection with any test-the-waters communications, including the use of certain disclaimers on any offering materials used for this purpose.

Character of the securities sold in a Regulation A offering

The securities sold in a Regulation A offering are not considered “restricted securities” under the Securities Act. As a result, the securities are not subject to any transfer restrictions and may be offered and sold to retail investors. This is important to an issuer that would like an active trading market to develop for its securities following completion of a Regulation A offering. However, the issuer’s securities may not be listed or quoted on a securities exchange, and, as a result, there may not be a liquid market for the securities.

The securities are not considered “covered securities” for blue sky purposes, as discussed below.

Reporting requirements

As discussed above, the Regulation A exemption is available only to certain issuers that are not SEC-reporting companies. Following its completion of a Regulation A offering, an issuer is not subject to ongoing disclosure obligations (unless it has undertaken multiple offerings and become subject to Exchange Act reporting requirements as a result of the dispersed nature of the holdings of its equity securities). As a result, there may be limited publicly available information about the issuer. The issuer may voluntarily choose to apply to have its securities listed or quoted on a national securities exchange, but it is not required to do so.

Finra review

For any public offering of securities, Finra Rule 5110 prohibits Finra members and their associated persons from participating in any manner unless they comply with the filing requirements of the rule.²⁸ Rule 5110 also contains rules regarding underwriting compensation. Rule 5110(b) requires that certain documents and information be filed with and reviewed by Finra, and these filing and review requirements apply to securities offered under Regulation A.²⁹

Considerations in conducting a Regulation A offering

Advantages

An exempt offering, including, for example, a Regulation D offering, is subject to several limitations, and a registered public offering may be too time-consuming and costly for an issuer. Using Regulation A to offer securities may provide an issuer with an offering format that is similar to a registered offering, but is more efficient. While there are many similarities between an offering circular and a prospectus, the preparation of an offering circular is generally simpler. An offering circular is less detailed than a prospectus for a registered offering. As a result, it is typically less costly for an issuer to conduct a Regulation A offering. The costs associated with external advisers, such as counsel and auditors, also will be lower in connection with a Regulation A offering. Also, management time devoted to the preparation of the offering circular will be less.³⁰ The review process undertaken by SEC staff is generally shorter than the review and comment process in connection with a full registration. A registration statement on Form S-1 would always be subject to complete review by the SEC staff in connection with an issuer's initial public offering. Timing is often the most important determinant of success for an offering. Inability to initiate an offering during a favourable market window may result in the issuer not being able to conduct an offering at all. Regulation A may provide flexibility to the issuer in this respect.

No limitation on offerees

Regulation A does not impose any limitations on offerees. In contrast to Rules 505 and 506 of Regulation D, Regulation A does not limit the number of offerees or investors that can participate in an offering, nor does it impose any requirement that offerees be accredited or sophisticated investors.

Nature of securities

Securities offered and sold pursuant to Regulation A are offered publicly and are not "restricted securities." The securities are freely tradable in the secondary market (assuming that there is a secondary market) after the offering. As a practical matter, the securities likely will trade on the Pink Sheets or in the over-the-counter (OTC) market unless the issuer has taken steps to list the class of securities on an exchange. No holding period applies to the holder of securities purchased in a Regulation A offering. Because an issuer may remain a non-reporting company after completion of a Regulation A offering, there may not be an active secondary market. If a smaller company

chooses to list a class of securities on a major exchange, it will become subject to Exchange Act reporting.³¹ Certain institutional investors have limitations on the amount that they may invest in "restricted securities." These restrictions generally would not apply to investments in securities issued pursuant to Regulation A.

Testing the waters, advertising, and general solicitation

The ability to test the waters in connection with a Regulation A offering may make a Regulation A offering more appealing (if the dollar threshold is increased) than a Regulation D offering, even with the relaxation of the prohibition on general solicitation for certain offerings made pursuant to Rule 506 of Regulation D,

Disadvantages

Dollar threshold

Although there are many significant benefits associated with a Regulation A offering, the dollar threshold undermines the benefits and reduces the utility of the exemption.³² Often an issuer will look to engage an underwriter to assist with structuring and marketing the offering. Similar to a registered offering, the underwriting effort may be on a best-efforts or a firm commitment basis. The recent history of Regulation A shows that it is unlikely that a large well-established broker dealer will underwrite a Regulation A offering. With the current offering threshold of \$5 million, participating in a Regulation A offering may not provide most broker-dealers with sufficient financial incentive. This is not a new issue – in fact broker-dealer participation was discussed in connection with the 1978 and 1992 amendments to Regulation A.³³ These concerns led to proposed legislation in Congress in March 2011 to amend section 3(b) of the Securities Act by increasing the offering threshold from \$5 million to \$50 million.

Requirement of state registration

Offerings made pursuant to Regulation A must satisfy state blue sky laws in each state where the offering is to take place. Critics argue that this is one of the big impediments to more active use of Regulation A.³⁴ Many states have not coordinated their exemptions to accommodate Regulation A offerings.³⁵ Regulation A securities currently are not "covered securities" within the meaning of section 18(b) of the Securities Act.³⁶ As a result, an offering likely will trigger a merit review in those states that are merit review states (unless waivers can be obtained), which may cause delays in qualifying Regulation A offerings. By comparison, offerings of securities listed on major exchanges (Nasdaq and NYSE) have been exempt from state review since 1996 pursuant to the NSMIA.³⁷

Similarly, securities offered pursuant to Rule 506 of Regulation D are exempt from state securities registration requirements.³⁸

Background on Regulation A reform

There have been various efforts to amend Regulation A. Commentators noted that, while over the years the offering threshold has been increased to the current \$5 million amount, the dollar amount has not kept pace with changes related to capital formation. The topic of increasing the Regulation A dollar threshold was discussed at the SEC's Government-Business Forum on Small Business Capital Formation on November 18 2010.³⁹ Moreover, in 2009, the recommendation to raise the dollar threshold made it into the final report of the SEC's Government-Business Forum on Small Business Capital Formation.⁴⁰

Statistics demonstrate that the offering threshold of Regulation A is too low and does not align with market realities.⁴¹ Observers have, in fact, highlighted this issue for a long time, because "the cost of making the offering, including fees for attorneys and accountants and printing costs consume an inordinate percentage of the proceeds of the offering."⁴² The threshold has not been increased for almost 20 years.⁴³ Smaller and emerging companies have faced many capital-raising challenges in recent years. Changes in market structure and other developments affecting the IPO market have led to a paucity of IPOs for smaller companies.⁴⁴ Smaller companies also have found the costs associated with being a public, reporting company increase.

Regulation A has not provided a viable capital-raising vehicle for smaller companies principally due to the low dollar threshold and the burdens associated with state blue sky compliance. In connection with a hearing before the House Committee on Financial Services on December 8 2010, regarding amending the Regulation A offering threshold to \$30 million, William R Hambrecht, chairman and CEO of WR Hambrecht + Co, stated that, "according to public records, since 2005 there have only been 153 Regulation A filings and of those 153, an astoundingly low number of 13 have actually priced."⁴⁵ Representative Barney Frank, who chaired the hearing, noted that the proposal to amend Regulation A should not be "a partisan or terribly controversial one." Hearing participants noted that the small IPO market has virtually disappeared. Representative Anna G Eshoo testified that, "[I]n 2004, there were 40 IPOs at \$50 million or less. In 2005, there were 38 IPOs at \$50 million or less. In 2009, there was one."⁴⁶

Following the financial crisis, concerns about the

availability of capital for smaller, emerging companies intensified, led, in March 2011, to the introduction of legislation that would have increased the Regulation A offering threshold. On March 14 2011, Representative David Schweikert introduced in the US House of Representatives the Small Company Capital Formation Act,⁴⁷ which was designed to encourage small companies to access the capital markets – allowing them to invest and hire employees.⁴⁸ In introducing the proposed legislation, Schweikert, vice-chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, said: "Taking a small business public is an important, but expensive process that requires millions in underwriting costs ... Raising the Regulation A threshold to \$50 million is one way to lower those costs and promote economic growth and job creation. At a time when so many small businesses are in need of capital, this is a common sense proposal that will make our capital markets more vibrant and competitive."⁴⁹

As discussed in the Introduction, the Small Company Capital Formation Act was part of a broader effort to address US job creation and economic competitiveness and to amend or repeal certain sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁵⁰ In connection with the legislative proposal, the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing on March 16 2011, regarding these legislative proposals to promote job creation, capital formation, and market certainty, including the Small Company Capital Formation Act.⁵¹ Industry representatives testified in support of the proposed Regulation A reform,⁵² as exemplified by testimony from David Weild, senior adviser of Grant Thornton, who provided an analysis of the devastating decline in numbers of small IPOs, demonstrating that small businesses and entrepreneurs cannot access the capital they need to grow and create jobs.⁵³ Weild applauded the Small Company Capital Formation Act as the beginning of a campaign to bring back the small IPO market. In addition to the cost benefits for small companies, he noted that an increased offering threshold opens up the Regulation A exemption to an offering size that would allow companies to list on the NYSE and NASDAQ and to avail themselves of the blue sky exemption, thus avoiding very costly state-by-state filings. Other observers voiced a preference for an increased Regulation A threshold combined with Congress also pre-empting state regulation for these offerings similar to Regulation D offerings. Weild also noted the importance of the test-the-waters provision of Regulation A, citing a steady increase in IPOs that are postponed,

withdrawn, priced below the low end of the IPO filing range or that have broken the IPO price within 30 days of the completion of the offering as potentially ruinous to smaller companies.⁵⁴

This legislation would have amended section 3(b) of the Securities Act by requiring the SEC to increase the aggregate offering amount to \$50 million for exempt offerings of securities. The legislation also would have amended section 18(b)(4) of the Securities Act by including in the definition of “covered security”:

a rule or regulation adopted pursuant to section 3(b)(2) and such security is —

- (i) offered or sold through a broker or dealer;
- (ii) offered or sold on a national securities exchange; or
- (iii) sold to a qualified purchaser ...”⁵⁵

Accordingly, certain Regulation A offerings would have been pre-empted from state blue sky review.⁵⁶

In June 2011, the House Committee on Financial Services approved an amendment to the Small Company Capital Formation Act, which provided that “the Commission *shall* require an issuer to file audited financial statements with the Commission annually” (our emphasis).⁵⁷ Title IV of the JOBS Act incorporates this reporting requirement in the context of the section 3(b)(2) exemption that it references.

The legislation was met with strong bipartisan support. In November 2011, the House of Representatives overwhelmingly approved the Small Company Capital Formation Act of 2011 by a vote of 421 to one. Companion legislation was introduced in the Senate in September 2011 by Senators Jon Tester and Pat Toomey. But for a few minor differences, the Senate bill was substantially similar to the Small Company Capital Formation Act. Ultimately, the changes that were contemplated in these bills were incorporated into the JOBS Act, albeit with some modifications.

It is important to note that, throughout the preceding few years, when commentators were considering amending Regulation A to increase the dollar threshold and address state blue sky matters, the proposals had as their underlying premise that smaller issuers that were not SEC-reporting companies would be able to conduct one or more Regulation A offerings and elect either to remain non-reporting issuers, or voluntarily seek to have their securities listed and quoted on a national securities exchange (thereby becoming SEC-reporting companies) and use Regulation A as an alternative to a traditional IPO. The notion of an IPO on-ramp, or scaled approach to IPOs for emerging growth companies, had not yet been proposed.

Title IV of the JOBS Act

As noted above, Title IV of the JOBS Act does not amend existing Regulation A. Instead, section 401 of the JOBS Act amends section 3(b) of the Securities Act by adopting a new section (b).

Pursuant to the new section 3(b)(2), the SEC is authorised to promulgate rules or regulations creating an exemption that is substantially similar to the existing Regulation A.

An issuer would be able to offer and sell up to \$50 million in securities within a 12-month period in reliance on the exemption. The issuer may offer equity securities, debt securities, and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities. The securities sold pursuant to the exemption will be offered and sold publicly (without restrictions on the use of general solicitation or general advertising) and will not be considered “restricted securities.” The issuer may test the waters or solicit interest in the offering before filing any offering statement with the SEC, subject to any additional conditions or requirements that may be imposed by the SEC. The civil liability provision in section 12(a)(2) of the Securities Acts applies to any person offering or selling such securities.

The securities will be considered “covered securities” for NSMIA purposes (and not subject to state securities review) if: the securities are offered and sold on a national securities exchange, or the securities are offered or sold to a “qualified purchaser” as defined under the Securities Act.⁵⁸ These provisions are more limited than those originally contained in the standalone Regulation A legislation. During the consideration of the Regulation A legislation, it became clear that perhaps the only significant source of controversy regarding modernising Regulation A related to state blue sky qualification. State securities regulators, through the North American Securities Administrators Association (Nasaa), expressed concerns about the potential for fraud and abuse related to offerings for small companies, including offerings completed pursuant to Regulation A. Nasaa opposed certain aspects of the proposals to modernise the regulation of these offerings that would involve broader state blue sky pre-emption.⁵⁹

The SEC will require that the issuer file audited financial statements with the SEC annually. The SEC may impose other terms, conditions or requirements deemed necessary for investor protection, including a requirement that the issuer prepare and file electronically with the SEC and distribute to prospective investors an offering statement and any related documents, including a description of the issuer’s business and financial condition, its corporate

governance principles, the intended uses of proceeds, and other appropriate matters. The SEC also may require an issuer that relies on the exemption to make available to investors and file with the SEC periodic disclosures. The bad actor disqualification provisions applicable for the exemption shall be substantially similar to the disqualification provisions contained in the regulations adopted pursuant to section 926 of the Dodd-Frank Act (which looks to the bad actor disqualification provisions in current Regulation A).

Not later than two years after enactment and every two years thereafter, the SEC shall review the offering threshold and report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate on its reasons for not increasing the dollar amount.

Required study on blue sky laws

Section 402 of the JOBS Act requires that the Comptroller General must conduct a study on the impact of blue sky laws on offerings made under Regulation A. Within three months of enactment of the Act, the Comptroller General must deliver the report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

The study titled *Factors that May Affect Trends in Regulation A Offerings* was delivered in July 2012.⁶⁰ The study notes that there are a number of factors that have contributed to the lack of utility of the Regulation A exemption, and highlights the time and expense associated with state blue sky compliance. The study concludes that without pre-emption of the state blue sky requirements, Regulation D may continue to be used in favour of Regulation A.

Proposed rules

On December 18 2013, the SEC issued proposed rules to carry out the rulemaking mandate of Title IV of the JOBS Act. The proposed rules both retain and modernise the framework of current Regulation A, by expanding Regulation A into two tiers. Tier 1 would preserve the current offering threshold in Regulation A, which permits an issuer to offer and sell up to \$5 million in any 12-month period, including no more than \$1.5 million in securities sold on behalf of selling stockholders. Tier 1 offerings would be subject to state securities review. Tier 2 would provide an exemption for offerings of up to \$50 million in any 12-month period, including no more than \$15 million in securities sold on behalf of selling stockholders. Offerings in both tiers are subject to the

same basic requirements relating to issuer eligibility, disclosure and other matters.

The offering exemption will be available to non-reporting companies organised in the United States or Canada, and would not be available to investment companies, companies delinquent in their filing requirements, and issuers subject to certain SEC orders. An issuer would be required to prepare and submit to the SEC for its review an offering statement. The offering statement may be submitted confidentially to the SEC for its review. The offering statement would then be filed electronically through EDGAR. Consistent with current Regulation A, issuers would be permitted to conduct test-the-waters communications. The proposed rules would incorporate a new investment limit for Tier 2 offerings. The proposed rules would limit the permissible amount to be invested by any individual to the greater of 10% of the individual's net worth or annual income. In addition, the proposed rules contain certain ongoing reporting requirements. An issuer that has conducted a Tier 2 Regulation A offering also will be required to make certain limited ongoing SEC filings.

In order to address the most significant impediment associated with current Regulation A, the proposed rules preempt state securities law review for Tier 2 Regulation A offerings (those up to \$50 million). The proposed rules do so by defining a "qualified purchaser" as any offeree or purchaser in a Tier 2 offering.

The comment period on the proposed rules closed on March 24 2014, but there is no assurance when the SEC will issue final rules.

The chart in Appendix A compares the current Regulation A requirements and the proposed Tier 1 and Tier 2 Regulation A exemptions.⁶¹

Continued debate regarding pre-emption of blue sky laws

There is a continuing debate among regulators, market participants and commentators regarding the pre-emption of state blue sky requirements for Tier 2 Regulation A offerings and whether such pre-emption will hurt investors or is necessary to ensure the widespread use of the offering exemption. On one side, there is concern that for Regulation A to be a workable exemption it must attract issuers that might otherwise choose more opaque exemptions for their capital raising needs. This may include Rule 506 offerings to accredited investors, where there are no disclosure requirements, no investment limit and no ongoing reporting obligations. In contrast, Tier 2 Regulation A offerings still provide enhanced investor protections.⁶² Furthermore, even with coordinated state

review, an issuer faced with a range of capital-raising alternatives, will not choose a Tier 2 Regulation A offering if state review is necessary.⁶³ On the other side, there is concern that without state review of Tier 2 Regulation A offerings, investors will lose an important protection. In addition, such pre-emption arguably contravenes the intent of Congress to have section 3(b)(2) apply to qualified purchasers (defined on the basis of sophistication and financial wherewithal and not simply the type of transaction being conducted) and securities offered and sold on a national securities exchange (which are already exempt from blue sky laws).⁶⁴

Use of the section 3(b)(2) exemption

Many clients have asked us why an issuer might choose to rely on section 3(b)(2) if the issuer could rely on Rule 506 of Regulation D. An exempt offering, including, for example, a Regulation D offering, may still be subject to several limitations that may not be appealing to an issuer, and a registered public offering may still be too time-consuming and costly. Using the new section 3(b)(2) provisions to offer securities can provide an issuer with an offering format that is similar to a registered offering with certain accompanying advantages, but may be more efficient. It might be especially appealing for an issuer to consider this type of offering as a precursor to an IPO. An issuer will be required to prepare and furnish certain offering disclosures in connection with a section 3(b)(2) offering, while there are no information requirements associated with a Rule 506 offering. In practice, however, most issuers will prepare some disclosure materials to share with prospective investors, even in a Rule 506 offering. An issuer may want to preserve the opportunity to approach investors that are not accredited, and may do so in connection with a section 3(b)(2) offering. Securities sold in a Rule 506 offering will be “restricted securities” that are subject to transfer restrictions. This may limit the market for the securities. An investor may have a preference for purchasing securities that are not “restricted securities” and that may be freely transferred.

A non-reporting company may choose to undertake a section 3(b)(2) offering or a Regulation D offering and remain below the shareholder threshold for required Exchange Act reporting. If it were to do so, a market for its securities may or may not develop. A non-reporting company that undertakes a section 3(b)(2) offering may also use the offering as an IPO.

The new section 3(b)(2) exemption should be flexible enough to facilitate a contemporaneous listing on a securities exchange for an issuer that elects to become a reporting company following completion of its section

3(b)(2) offering. An emerging company may be able to satisfy the market capitalisation and public float requirements of a securities exchange upon completion of its section 3(b)(2) offering. Under current law, if an issuer were to seek to list its securities on a national securities exchange in conjunction with, or following the completion of, a section 3(b)(2) offering, it would be required to prepare and file with the SEC a registration statement on Form 10. Many of the comment letters submitted to the SEC on Title IV of the JOBS Act have suggested that the SEC modify the approach to Exchange Act registration for those issuers that choose to use a section 3(b)(2) offering as an IPO. Now, of course, an issuer that qualifies as an emerging growth company also would be able to avail itself of the Title I on-ramp approach. A traditional IPO, even with the accommodations now made available to emerging growth companies by Title I, may not be a realistic alternative for smaller companies. Many investment banks will only undertake an IPO if it is of a certain size, and smaller companies may still seek to undertake IPOs in which they offer up to \$50 million in securities. For smaller IPOs of the sort that were once common in the United States, the section 3(b)(2) alternative may prove the only realistic approach. Ultimately, however, and as noted in the GAO study on Regulation A offerings, the utility of the new exemption will depend entirely on the final rules.

Appendix A			
Current Regulation A requirements as compared with the proposed Tier 1 and Tier 2 Regulation A exemptions			
	Regulation A Exempt Public Offering	Tier 1 of Proposed Regulation A	Tier 2 of Proposed Regulation A
Offering Limit	Up to \$5 million within the prior 12-month period.	Up to \$5 million in a 12-month period.	Up to \$50 million in a 12-month period.
SEC Filing Requirements	Must file with the SEC a Form 1-A, which is reviewed by the SEC Staff.	Must file with the SEC a Form 1-A, which must be reviewed and declared effective.	Must file with the SEC a Form 1-A, which must be reviewed and declared effective.
Blue Sky Requirements	Blue sky law compliance is required, without, in many cases, the possibility for a more streamlined “registration by coordination” process.	Blue sky law compliance is required.	Exempt from state law review, for offerings to qualified purchasers or where securities are listed on a national securities exchange.
Limitations on Investors	No limits on investors, except to the extent imposed under state laws.	No limits.	No limits on offerees. Investment limit applicable.
Restrictions on Resale of Securities	No restrictions on the resale of securities, except to the extent that the securities are held by affiliates.	No restrictions on the resale of securities.	No restrictions on the resale of securities.
Offering Communications	An issuer may “test the waters” to determine if there is interest in a proposed offering prior to filing the Form 1-A. Sales literature may be used before the filing of the Form 1-A, after filing, and following qualification.	An issuer may test the waters with all investors. Solicitation materials must be filed with the SEC.	An issuer may test the waters with all investors. Solicitation materials must be filed with the SEC.
Financial Statement Requirements	A current balance sheet, as well as income statements for a period of two years, as well as any interim period. Financial statements must be prepared in accordance with GAAP but do not have to conform to Regulation S-X and, in most cases, do not have to be audited.	<ul style="list-style-type: none"> Audited financial statements only if prepared for other purposes. If audited, then must be audited by an independent accountant, but not required to be PCAOB-registered. Current balance sheet, income statement for two years, as well as any interim period. 	<ul style="list-style-type: none"> Audited financial statements required, reviewed by an independent accountant and prepared in accordance with PCAOB standards.
Disqualification Provisions	Felons and bad actors disqualified from the offering in accordance with Securities Act Rule 262.	Felons and bad actors disqualified; Rule 262 updated.	Felons and bad actors disqualified; Rule 262 updated.
Ongoing Reporting	No reporting required after the offering, other than to disclose the use of proceeds.	A termination report required.	Yes. A Tier 2 issuer will be subject to filing requirements, including a requirement to file: periodic reports; semi-annual reports; and an annual report, until obligations are terminated or suspended.

ENDNOTES

1. Securities Act Release No. 66, 1933 WL 28878 (November 1 1933).
2. Regulation A consists of Rules 251 through 263. 17 CFR §§ 230.251–.263, hereinafter cited by rule number.
3. See Pub. L. No. 96-477, § 301, 94 Stat. 2275, 2291 (1980).
4. See Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (July 30 1992).
5. President Bush announced: “[the] goal . . . is to . . . eliminate or revise those [securities laws] that clearly impose costs that exceed their benefits, and [to] ensure that other regulations are implemented in a cost-effective manner.” Council of Economic Advisers, *The Annual Report of the Council of Economic Advisers*, in ECONOMIC REPORT OF THE PRESIDENT, 191 (1992).
6. The SEC highlighted in the proposing release the decline in the number of small business IPOs between 1986 and 1991 as well as the declining number of Regulation A filings between 1981 and 1991. See Securities Act Release No. 6,924, 1992 WL 52840 (March 11 1992) (“Since 1986, equity IPOs have declined each year until the turnaround in 1991. Forty-four Regulation A financings were filed in FY 1991 with the Commission, representing financings of \$41.5 million, in contrast with 439 filings covering financings of \$408 million in FY 1981.”).
7. See *id.* (“Small businesses are the cornerstone of the U.S. economy. The approximately 20 million small businesses in the United States employ more than half of the domestic labor force, produce nearly half of the gross domestic product and created the vast preponderance of new jobs during the period from 1988 through 1990.”).
8. See Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (July 30 1992).
9. See *id.* at *2.
10. See generally Rules 251–63. 17 CFR §§ 230.251–.263.
11. Rule 251(a)(1). An issuer that is a corporation, an unincorporated association, or a trust must be incorporated or organized “under the laws of the United States or Canada, or any State, Province, Territory or possession thereof, or the District of Columbia.”
12. Rule 251(a)(2). The requirement that the issuer is a non-reporting company was added to Regulation A in 1992. See Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (July 30 1992).
13. Rule 251(a)(3). The term “development stage company” is not defined in Regulation A or Rule 405. However, the adopting release makes clear that Rule 251(a)(3) is intended to disqualify only “blank check” companies. See 1992 WL 188930, at *3.
14. Rule 251(a)(4).
15. Rule 251(a)(5). Note that Rule 251(a)(5) does not prevent companies in the oil and gas industry from using Regulation A for offerings of, for example, their common stock or bonds.
16. See Rule 262(a), (b), and (c).
17. See Rule 251(b).
18. Rule 251(d)(3).
19. Rule 253(e)(2).
20. Rule 251(c)(2)(v).
21. See Rule 252(e) and (g).
22. See Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (July 30 1992).
23. Rule 253(a).
24. See Form 1-A, Part II. 17 CFR § 239.90.
25. See Form 1-A, Part F/S. If the issuer has been in business for less than two years, financial statements for that shorter period are required. *Id.*
26. *Id.*
27. Rule 254(a).
28. See Finra Rule 5110.
29. See NASD Notice to Members 92-28 (May 1992); see also NASD Notice to Members 86-27 (April 1986).
30. The SEC has emphasized this advantage in the past. See, e.g., Securities Act Release No. 5977, 1978 WL 196028, at *2 (September 11 1978).
31. An issuer may choose to prepare and file a Form 10 to register one or more classes of securities under section 12 of the Exchange Act with the SEC.
32. See *A Proposal to Increase the Offering Limit Under SEC Regulation A: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. (2010) (statement of Michael Lempres, Asst. Gen. Counsel, SVB Financial Group) (“The impetus behind the creation of regulation A was very good one. Unfortunately, in recent years, as you’ve been

- hearing, regulation A has not proved to be a useful capital raising vehicle for small issuers. It was used only a total of 78 times during the 10-year period between 1995 and 2004. An average of eight filings a year with the maximum amount of \$5 million each really proves the irrelevance of regulation A in today's economy. It's simply not a viable vehicle as currently structured.”).
33. See Small Offering Exemption, Securities Act Release No. 5997, 1978 WL 171024 (November 16 1978) (proposed amendment dealing with firm underwriting); see also Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (July 30 1992).
 34. See, e.g., *Lawmakers Propose Raising Regulation A Offering Limit*, PIPES REP. (December 21 2010).
 35. Some states offer “coordinated review” (CR), allowing issuers to receive the comments from one CR office even though the Regulation A offering is to be conducted in several states, which reduces the review process and costs. CR-SCOR is a program that “provides for coordinated review of an offering of securities in two or more states located within a geographic group when the offering is intended to be made in reliance upon an exemption from registration with the US Securities and Exchange Commission (SEC) under Rule 504 of SEC Regulation D or SEC Regulation A.” CR-SCOR, www.coordinatedreview.org/crscor.html (last visited October 7 2011). New York, California, and Florida are not participating in the CR-SCOR programme.
 36. Securities Act § 18(b), 15 USC § 18(b).
 37. National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3435 (October 11 1996). NSMIA preempts state qualification and registration requirements for “covered securities,” which includes issuer offerings of securities listed on Nasdaq or the NYSE and securities exempt from registration under federal securities law, including pursuant to rules promulgated under section 4(a)(2) of the Securities Act.
 38. Rules 504 and 505 were promulgated under section 3(b) of the Securities Act and do not preempt state securities law requirements. However, most states have adopted changes to their state securities laws that essentially duplicate the provisions of Regulation D.
 39. See 29th ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, RECORD OF PROCEEDINGS (November 18 2010) (statement of David Hirschmann, President and CEO of the Center for Capital Markets Competitiveness at the US Chamber of Commerce).
 40. See 2009 ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION 17 (2009).
 41. See Statement of William R. Hambrecht, Chairman & Chief Exec. Officer, WR Hambrecht + Co.) (“According to public records, since 2005 there have only been 153 Reg A filings and of those 153, an astoundingly low number of 13 have actually priced.”).
 42. *Hearing on Capital Formation Before the S. Subcomm. on Small Business*, 95th Cong. 589 (1978) (statement of Sen. Lowell Welcker).
 43. See *A Proposal to Increase the Offering Limit Under SEC Regulation A: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 3 (2010) (statement of Rep. Anna Eshoo, Member of Congress, Cal.) (“The main problem is that hardly anybody uses it. Currently, there is little incentive to support the small initial public offerings under Regulation A. In fact, the current regulations are a disincentive, burdening a \$5 million offering with \$1 million to \$2 million in underwriting expenses. So that is a pretty good reason why people aren't using it.”).
 44. Smaller IPOs suffered a “rapid decline” from 1996 to 2000. Before 1996 there was an average of 520 IPOs per year, after 2000 there was only an average of 134 IPOs per year. DAVID WEILD & EDWARD KIM, WHY ARE IPOs IN THE ICU, 3, 7 (Grant Thornton 2008), available at www.grantthornton.com/staticfiles/GTCom/files/GT%20Thinking/IPO%20white%20paper/Why%20are%20IPOs%20in%20the%20ICU_11_19.pdf.
 45. See *A Proposal to Increase the Offering Limit Under SEC Regulation A: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 32 (2010) (prepared statement of William R. Hambrecht, Chairman & Chief Exec. Officer, WR Hambrecht + Co.).
 46. See statement of Rep. Anna G. Eshoo, Member of Congress, Cal.
 47. See Small Company Capital Formation Act of 2011, HR 1070, 112th Cong. (1st Sess. 2011).
 48. See Press Release, Fin. Servs. Comm., Administration Could Help Small Business Gain Access to Capital by Helping Pass the Small Company Capital Formation Act (March 22 2011), available at

- <http://financialservices.house.gov/News/DocumentPrint.aspx?DocumentID=236861>.
49. See press release issued by the House Financial Services Committee, *available at* <http://financialservices.house.gov/press/PRArticle.aspx?NewsID=1817>.
 50. Pub. L. No. 111-203, 124 Stat. 1376 (July 21 2010) [hereinafter Dodd-Frank].
 51. See Press Release, Fin. Servs. Comm., Administration Could Help Small Business Gain Access to Capital by Helping Pass the Small Company Capital Formation Act (March 22 2011), *available at* <http://archives.financialservices.house.gov/press/PRArticle.aspx?NewsID=1817>.
 52. See generally *Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty Before the Subcomm. on Capital Markets and Gov. Sponsored Enterprise of the H. Comm. on Fin. Servs.*, 112 Cong. 24 (2011).
 53. *Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty Before the Subcomm. on Capital Markets and Gov. Sponsored Enterprise of the H. Comm. on Fin. Servs.*, 112 Cong. 24 (2011) (prepared statement of David Weild, Senior Advisor, Grant Thornton LLP).
 54. See DAVID WEILD & EDWARD KIM, GRANT THORNTON LLP, CAPITAL MARKET SERIES: MARKET STRUCTURE IS CAUSING THE IPO CRISIS (October 2009), *available at* www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/File%20IPO%20crisis%20-%20Sep%202009%20-%20FINAL.pdf.
 55. See Amendment in the nature of a substitute to HR 1070 offered by Mr. Schweikert, no. 1, *available at* <http://financialservices.house.gov/UploadedFiles/062211hr1070schweikertam.pdf>.
 56. As originally proposed, the legislation did not provide for a state blue sky law exemption.
 57. Amendment to the Amendment in the Nature of a Substitute to HR 1070 Offered by Mr. Ackerman, no. 1a (emphasis added), *available at* <http://financialservices.house.gov/UploadedFiles/062211hr1070ackermanam.pdf>. As originally proposed, the legislation provided that the SEC *may* require an issuer to file audited financial statements with the SEC and distribute such statements to prospective investors.
 58. Currently, there is no definition under the Securities Act of a “qualified purchaser.” The SEC would be required to adopt a definition.
 59. See Letter from David S. Massey, North Carolina Deputy Securities Administrator, NASAA President, to Spencer H. Bachus, Chair., House Financial Services Committee, *et al.* (June 15 2011), *available at* www.nasaa.org/wp-content/uploads/2011/07/6-15-11-NASAA_Comment_Letter_HR1070_HR1082.pdf.
 60. See study *available at* <http://www.gao.gov/assets/600/592113.pdf>.
 61. This chart originally appeared in Morrison & Foerster’s alert, “A+ Indeed: The SEC’s Proposed Rules Amending Reg A,” *available at* <http://www.mofo.com/files/Uploads/Images/131219-Reg-A.pdf>.
 62. See speech of Commissioner Luis A. Aguilar titled “NASAA and the SEC: Presenting a United Front to Protect Investors” (April 8 2014), *available at* <https://www.sec.gov/News/Speech/Detail/Speech/1370541436767#.U2QgyhND-Hs>.
 63. Tier 2 Regulation A offerings also are unlikely to be “local” in nature and Statements of Policy applied by state regulators have not been updated in a meaningful way, may slow down the offering process without providing meaningful investor protections and are inconsistent with practices in “public offerings,” which Tier 2 Regulation A offerings are more similar to than private placements. For example, many states require that each investor in their state sign a subscription agreement, which is not used in a registered offering that clears and settles through The Depository Trust Company (DTC) and is sold by a broker-dealer. A recent state review also triggered comments from examiners inquiring about the rules of DTC and requested more information about Cede & Co, DTC’s nominee, as well as about the officers, directors and purpose/role of Cede & Co.
 64. See letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, to the SEC (December 18 2013), *available at* <https://www.sec.gov/comments/s7-11-13/s71113-1.pdf>.

CHAPTER 7

Exchange Act registration thresholds

Before the enactment of the JOBS Act, Exchange Act section 12(g) required registration of a class of an issuer's equity securities if, as of the last day of the issuer's fiscal year, the issuer had more than \$10 million in assets and the class of equity securities was held of record by 500 or more persons.¹ Once these thresholds were crossed, an issuer would have to register the class of equity securities within 120 days of the end of the fiscal year, and then begin filing current and periodic reports with the SEC.² The definition of "held of record" for these purposes counts as holders of record only persons identified as owners on records of security holders maintained by the company, or on its behalf, in accordance with accepted practice. An issuer could only deregister a class of equity securities under section 12(g) when such class of equity securities is held of record by less than 300 persons, or by less than 500 persons and the total assets of the issuer has not exceeded \$10 million on the last day of each of the issuer's three most recent fiscal years. Exchange Act section 12(g) was originally enacted out of concern that issuers who were not listed on a national securities exchange could nonetheless be widely held and traded over the counter, and therefore disclosure should be available to investors in such issuers through SEC registration and reporting.

Leading up to the JOBS Act changes to the Exchange Act registration/deregistration thresholds, concerns were raised about the fact that the 500 person held-of-record threshold had not been revisited since 1964. These concerns focused on the fact that issuers sometimes had to go public sooner than they might otherwise want to by virtue of the mandatory registration provisions in section 12(g), and the possibility of SEC registration and reporting could serve to discourage private companies from raising capital and using equity awards to compensate employees. At the same time, concerns were expressed with issuers going dark and ceasing their SEC reporting by bringing the number of holders of record below the deregistration threshold. As a result of these concerns, a variety of proposals were advanced relating to possible amendments to section 12(g) registration thresholds. Some of these proposals sought to reduce the number of issuers

required to report pursuant to the Exchange Act, for example, by raising the shareholder threshold,³ by excluding employees, or by excluding accredited investors, QIBs or other sophisticated investors from the calculation.⁴ The SEC also received a rulemaking petition requesting that the SEC revise the held of record definition to look through record holders to the underlying beneficial owners of securities in order to prevent issuers from ceasing to report in certain circumstances.⁵ Before April 5 2012, the SEC was conducting a comprehensive study of these issues and was actively considering the various proposals.

Raising the registration and deregistration thresholds in Titles V and VI

As amended by Titles V and VI, Exchange Act section 12(g) now requires registration of a class of equity securities if, at the end of its fiscal year, an issuer has at least \$10 million in assets and a class of equity securities held of record by either 2,000 persons, or 500 persons who are not accredited investors. Banks⁶ and bank holding companies⁷ are not required to register unless they have, at the end of the fiscal year, at least \$10 million in assets and a class of equity securities held of record by 2,000 or more persons. Under Exchange Act section 12(g)(4) before the enactment of the JOBS Act, an issuer could deregister a class of equity securities when either the issuer has \$10 million or less in assets and the class of equity securities is held by fewer than 500 holders of record, or the class of equity securities was held by fewer than 300 holders of record. The JOBS Act increased the 300 persons held-of-record threshold in Exchange Act section 12(g)(4) only with respect to banks and bank holding companies, raising that threshold from 300 to 1,200 persons. The JOBS Act did not increase the 300 persons held-of-record threshold for deregistration for issuers that are not banks or bank holding companies.

Under the JOBS Act, Exchange Act section 12(g)(5) was amended to provide that the term "held of record" does not include "securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act." The SEC is directed to

amend its Rule 12g5-1 definition of “held of record” to reflect this amendment to the statute. The SEC also is directed to adopt safe harbour rules for issuers to follow in determining whether holders of their securities received the securities pursuant to “an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933,” and securities sold in exempt crowdfunding offerings will also not be included in determining whether registration is required under section 12(g).

On April 11 2012, the Division of Corporation Finance issued Frequently Asked Questions on Changes to the Requirements for Exchange Act Registration and Deregistration, which confirmed that the Title V and Title VI provisions raising the Exchange Act registration/deregistration thresholds were, for the most part, immediately effective, thereby providing issuers with the ability to avoid registration in 2012 and going forward, and, specifically with regard to bank holding companies, to terminate their registration/reporting obligation.⁸

In Frequently Asked Question 4, the SEC noted that if a bank holding company with a class of equity securities held of record by less than 1,200 persons as of the first day of the current fiscal year has a registration statement that is updated during the current fiscal year pursuant to Securities Act section 10(a)(3), but under which no sales have been made during the current fiscal year, then the bank holding company may be eligible to seek no-action relief to suspend its section 15(d) reporting obligation. The Staff has now been granting these no-action letters.⁹

As mentioned above, section 503 of the JOBS Act requires the SEC to revise the definition of “held of record” to exclude, from the section 12(g)(1) holder of record calculation, persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act; however, the SEC has not yet proposed or adopted any implementing rules. In Frequently Asked Question 5, the SEC noted that an issuer (including a bank holding company) may exclude persons who received securities pursuant to an employee compensation plan in Securities Act-exempt transactions, whether or not the person is a current employee of the issuer. While section 503 of the JOBS Act directs the Commission to adopt “safe harbor provisions that issuers can follow when determining whether holders of their securities received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933,” in the SEC’s view the lack of a safe harbour does not affect the application of Exchange Act section 12(g)(5).

Required study

The SEC was required to examine its authority to enforce Rule 12g5-1 to determine if new enforcement tools are required to enforce the anti-evasion provision contained in (b)(3) of the rule, and to provide recommendation to Congress within 120 days of the enactment of the JOBS Act. On October 16 2012, the SEC staff published the results of this mandated study, concluding that the statutes, rules and procedures as currently formulated provide the Division of Enforcement with sufficient tools to investigate and bring a case for section 12(g) violations based on section 12g5-1(b)(3).¹⁰

Treatment of savings and loan holding companies

On November 28 2012, Representatives Steve Womack (R-AR) and Jim Himes (D-CO) asked former SEC chairman Schapiro to extend to savings and loan holding companies (SLHCs) the benefits of the JOBS Act increase in the section 12(g) registration threshold from 500 to 2,000 for banks and bank holding companies. Similarly, the Congressmen believed that JOBS Act-mandated increase in the deregistration threshold for banks and bank holding companies from 300 to 1,200 should also be made available to SLHCs. They noted that, as sponsors of the original bill, they had not intended to treat SLHCs differently from banks and bank holding companies. While the Title V and VI changes were effective on enactment, the letter stated the hope that the SEC, when it updated its rules to reflect JOBS Act changes, would treat SLHCs in the same manner as bank holding companies.

On May 8 2013, Senator Toomey (R-PA) introduced a bill (S. 872) in the Senate to amend section 12(g) to make the shareholder threshold for registration of SLHCs the same as for bank holding companies, however it was not passed. On January 13 2014, Representatives Steve Womack (R-AR), Jim Himes (D-CO), John Delaney (D-MD) and Ann Wagner (R-MO) introduced to the House of Representatives for consideration similar legislation, the Holding Company Registration Threshold Equalization Act (H.R. 801), which was passed and will be sent to the Senate next for consideration.

Appendix A SHAREHOLDER TRIGGERS		
	Companies other than banks and BHCs	Banks and BHCs
Total assets at fiscal year-end that trigger reporting requirement if shareholder trigger is breached	\$10 million	\$10 million
Total number of holders of record that trigger reporting	2,000 holders of record OR 500 non-accredited holders of record	2,000 holders of record
Total number of holders of record to exit reporting	300 or fewer holders of record	1,200 or fewer holders of record
Effectiveness	Immediately effective	At the end of the issuer's first fiscal year following enactment of the JOBS Act

ENDNOTES

1. These thresholds were set forth in Exchange Act § 12(g)(1) and Exchange Act Rule 12g-1. When section 12(g) was enacted in 1964, the asset threshold was set at \$1 million. The asset threshold was most recently increased to \$10 million in 1996. SEC Release No. 34-37157 (May 1 1996), *available at* <http://www.sec.gov/rules/final/34-37157.txt>.
2. In addition, section 16 reporting and short-swing liability apply to insiders, beneficial ownership reporting applies to significant stockholders, the SEC's proxy rules apply to the issuer, and the various Sarbanes-Oxley Act and Dodd-Frank Act provisions apply as a result of Exchange Act section 12(g) registration.
3. *See, e.g.*, Comment Letter from American Bankers Association to SEC (November 12 2008), *available at* <http://www.sec.gov/rules/petitions/4-483/4483-21.pdf>.
4. *See, e.g.*, 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), *available at* <http://www.sec.gov/info/smallbus/gbfor28.pdf>.
5. Petition from Lawrence Goldstein to SEC (February 24 2009), *available at* <http://www.sec.gov/rules/petitions/2009/petn4-483-add.pdf>. *See also* Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3 2003), *available at* <http://www.sec.gov/rules/petitions/petn4-483.htm>.
6. Under Exchange Act section 12(i), banks do not register their securities or file reports with the SEC.
7. The term “bank holding company” is defined in the Bank Holding Company Act of 1956.
8. Frequently Asked Questions on Changes to the Requirements for Exchange Act Registration and Deregistration (April 11 2012), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfjjob_sactfaq-12g.htm.
9. *See, e.g.*, *Peoples Financial Services Corp.* (August 16, 2012); *Central Virginia Bankshares, Inc.* (August 8, 2012); *AB&T Financial Corporation* (July 27 2012); *Botetourt Bankshares, Inc.* (July 24 2012); *First Ottawa Bankshares* (July 23 2012); *Potomac Bancshares, Inc.* (July 23 2012); *Skagit State Bancorp, Inc.* (July 20 2012); *Touchmark Bancshares, Inc.* (July 17 2012).
10. *Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3)* (October 15 2012), *available at* <http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf>.

CHAPTER 8

Research

As discussed in the Introduction, the capital markets have undergone significant changes in the last decade. In 2003, as a result of legal and regulatory developments, the business of research coverage changed quickly and fundamentally. These changes were brought about as a result of the entry by a number of investment banking firms into the Global Research Analyst Settlement (the Global Settlement), the adoption of SRO rules relating to research, and the promulgation by the SEC of Regulation AC. The Global Settlement addressed the most serious perceived conflicts between investment banking and research departments during the dot-com boom, and required implementation of various prophylactic measures by investment banking firms that provided research coverage, including separating banking and research structurally and physically, requiring a chaperone to monitor communications between the two, and requiring analyst compensation be determined independently and not be based on banking revenues. Regulation AC was designed to ensure research analyst independence and integrity by requiring that research analysts certify the truthfulness of the views expressed in research reports and public appearances. The rules adopted by the NASD (Finra's predecessor) and NYSE followed along the same lines and also addressed the timing of research reports in connection with offerings. In addition to imposing significant compliance burdens, together, the Global Settlement and the rules and regulations relating to research also brought about a significant cultural shift, and changed fundamentally the role of research analysts and the business of research coverage.¹ In part, as a result of these changes, research coverage for smaller companies declined. As noted in the IPO Task Force Report, the lack of research coverage adversely impacts trading volumes, company market capitalisations and the total mix of information available to market participants. In order to promote capital formation by emerging growth companies, the IPO Task Force Report recommended that policymakers consider the existing restrictions on research, and adopt measures to encourage additional research coverage of emerging growth companies in order to improve the flow of information. Title I of the JOBS Act addresses certain of the concerns

raised by the IPO Task Force Report by implementing a number of changes to the restrictions on the timing of, and on the publication of, research reports relating to emerging growth companies. As discussed below, however, the JOBS Act does not address the research safe harbours contained in the Securities Act, nor does it address the regulations that mandate the separation of research and investment banking functions. In order to put the JOBS Act research-related changes in context, below we provide a summary of the rules and regulations governing the research function and the release of research reports.

The regulatory framework applicable to research

The rules and regulations that apply to the relationship between the research and investment banking departments of an investment banking firm include: Finra Conduct Rule 2711; NYSE Rule 472; SEC Regulation AC (Analyst Certification); and Rules 137, 138, and 139 under the Securities Act. In addition, certain firms are bound by the terms of the Global Settlement.

During the dot-com boom, research analysts published reports recommending investments in the securities of many companies with which their firms had an advisory or investment banking relationship. In 1999, the SEC began a review of industry practices regarding the disclosure of research analysts' conflicts of interest. Committees of the US House of Representatives and the Senate also held hearings on research analysts' conflicts of interests. In April 2002, the SEC announced a formal inquiry into industry practices concerning research analysts, their conflicts of interest and their relationships with the investment banking departments within their firms. Civil complaints were filed by the SEC and other federal and state regulatory and law enforcement authorities against these firms. The Global Settlement is an enforcement agreement first announced in December 2002 and finalised on April 28 2003, among the SEC, NASD (now Finra), the NYSE, the New York State Attorney General and 10 of the then-largest investment banking firms in the United States (referred to here as the settling firms). As part of the Global Settlement, the settling firms agreed to several measures

designed to prevent abuse stemming from pressure by investment bankers on research analysts to provide favourable coverage of specific issuers or securities. The settling firms were required to separate their investment banking and research departments from each other both physically and with information firewalls. Additionally, the budget allocation for research was to be independent of investment banking. Research analysts were also prohibited from attending IPO pitches and road shows with investment bankers. Finally, research analysts' previously issued ratings about issuers had to be disclosed and made available. In addition to these regulatory actions, each settling firm was enjoined from violating the statutes and rules that it was alleged to have violated, and were also required to pay fines to their investors, fund investor education and pay for independent third-party market research. The Global Settlement remains in effect, although its terms have been modified from time to time.

The Sarbanes-Oxley Act required the SEC to address conflicts of interest involving research analysts and investment bankers. In response to Sarbanes-Oxley, the NASD and the NYSE established rules and safeguards to separate research analysts from the review, pressure and oversight of investment banking personnel. These rules are intended to ensure the integrity of research and to protect investors from being misled as a result of a failure to disclose potential conflicts of interest. On July 29 2003, the SEC announced the approval of a series of changes to the rules affecting research analysts, generally embodied in Finra Rule 2711 and NYSE Rule 472 and referred to as the SRO rules. The SRO rules have since been amended many times (most recently on October 11 2012 to conform the SRO Rules to provisions of the JOBS Act).

The Global Settlement and SRO rules address reporting lines, requiring that research and investment banking be separate units, and research not report to banking. Research must be physically separated from investment banking. This physical separation must be reasonably designed to ensure that there will not be any intentional or unintentional flow of information between research and investment banking. Research must have its own resources for compliance and legal services. In addition, the research budget may not be controlled by investment banking, and compensation for research personnel cannot be tied to investment banking business or revenues.²

Both the SRO rules and Regulation AC mandate that research reports include certain disclosures. Research reports must include disclosures relating to any actual or potential conflicts of interest. For example, a research report must disclose whether a firm does or seeks to do business with the company covered by the report; whether

it has received, or expects to receive, compensation from the subject company within a specified time period; and whether analysts or other persons own securities of the subject company. Regulation AC requires that reports contain prominent certifications regarding the views expressed in the research report, and attesting that the analyst's compensation was not tied to or related to specific recommendations or views expressed by the research analyst in the research report.

The Global Settlement also limits the participation of research personnel in offering related activities. Research personnel may not participate in efforts to solicit business for investment banking, including, among other things, participating in any pitches, or otherwise communicating with a company or prospective client for the purpose of soliciting investment banking business.³ Further, SEC interpretive guidance states that it would be inconsistent with section I.9 of Addendum A to the Global Settlement to allow investment banking personnel to include any information regarding any research analyst employed by the firm in a pitch book or any other presentation materials used to solicit investment banking business. Research personnel are not allowed to participate in any road shows sponsored by the company or investment banking related to a public offering or other investment banking transaction. However, SEC interpretive guidance provides that research personnel may listen (in listen-only mode) or view a live webcast of these road shows. Research personnel may also access other widely attended presentations to investors from a remote location, but if the presentation is in the firm's building, they must be in a separate room.

The Global Settlement permits certain communications between a research analyst and an issuer in connection with an offering. At an issuer's request, investment banking personnel may arrange for a department of the firm other than research to provide the issuer access to previously published reports regarding that issuer that would be available from other sources. Should an issuer request investment banking personnel to arrange a meeting between the issuer and a research analyst, the investment bankers must instruct the issuer to contact research directly and may not notify research in advance. A research analyst is permitted to attend a meeting with an issuer and answer questions regarding the analyst's views on the company, but may not use it as an opportunity to solicit investment banking business, and investment banking personnel may not be present or participate in any of these meetings.

The SRO rules subject member firms to quiet periods during which they may not publish research and during which analysts may not make public appearances following

initial and secondary offerings and around the termination, waiver or expiration of lock-up agreements, subject to certain exceptions.

Restrictions on communications affecting research

In addition to these rules and regulations that affect the structure and business of research coverage, the Securities Act imposes restrictions on offering related communications that impact the dissemination of research reports.

A research report⁴ may be considered an offer or a non-conforming prospectus under the Securities Act. Information, opinions, or recommendations by a broker-dealer about securities of an issuer proposing to register securities under the Securities Act may constitute an offer to sell such securities, particularly when the broker-dealer participates in the distribution as an underwriter or member of the selling group.⁵ The issuance of a research report in advance of a public offering could also technically constitute gun-jumping (the illegal solicitation of an offer before a registered offering) and, as a result, a section 5 violation.

Until relatively recently, the nature and content of communications made around the time of a securities offering were generally very limited because the SEC took an expansive view of the concept of an offer. Under section 2(a)(3) of the Securities Act, an offer is defined broadly and includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.⁶ Before an issuer filed a registration statement, all offers in any form were prohibited.⁷ Between the filing of the registration statement and its effectiveness, the only written offers that were permitted were those filed with the SEC and that conformed to the requirements applicable to a statutory prospectus under section 10 of the Securities Act.⁸ After the registration statement was declared effective, written materials still were required to meet the section 10 prospectus requirements. Additional offering-related materials were permitted only if a final prospectus (conforming to the section 10(a) requirements) was delivered before or along with the additional materials.⁹ These limitations did not relate to the accuracy or content of the communications. Any violation of these rules was considered gun jumping.¹⁰ The SEC's restrictive position was founded on the belief that "the means of communications were limited and restricting communications (without regard to accuracy) to the statutory prospectus appropriately balanced available communications and investor protection."¹¹

In 2004, the SEC decided to revamp the securities

offering communications regime. In its release proposing the Securities Offering Reform the SEC stated:

The capital markets, in the United States and around the world, have changed significantly since those limitations were enacted. Today, issuers engage in all types of communications on an ongoing basis, including, importantly, communications mandated or encouraged by our rules under the Exchange Act. Modern communications technology, including the Internet, provides a powerful, versatile, and cost-effective medium to communicate quickly and broadly. [footnote omitted] The changes in the Exchange Act disclosure regime and the tremendous growth in communications technology are resulting in more information being provided to the market on a more non-discriminatory, current and ongoing basis. Thus, while the investor protection concerns remain, the gun-jumping provisions of the Securities Act impose substantial and increasingly unworkable restrictions on communications that would be beneficial to investors and markets and consistent with investor protection.¹²

As a result, as part of its 2005 Securities Offering Reform, the SEC redesigned the regulation of communications in order to limit the types of communications that would be deemed offers for purposes of section 5 of the Securities Act or prospectuses for purposes of section 12(a)(2) of the Securities Act. In connection with Securities Offering Reform, the SEC broadened the existing safe harbours under the Securities Act for certain research reports, which are contained in Rules 137, 138, and 139. These safe harbours for certain research reports apply to all types of issuers (as opposed to the JOBS Act's provisions which apply only to emerging growth companies, or EGCs) who meet the requirements of Rules 137, 138 and 139. The safe harbours expressly exclude research reports from the definition of offers, offers for sale, and offers to sell¹³ under section 5¹⁴. Note that the safe harbours only apply to research reports distributed in advance of or during a public offering, a Rule 144A offering or a Regulation S offering.¹⁵ It is unlikely, however, that a research report that meets the requirements set forth in the safe harbours would be considered a "general solicitation" in the context of a private placement.

Rules 137, 138, and 139 are designed to protect analysts, brokers, and dealers from general solicitation and gun-jumping violations in connection with their regularly disseminated research reports. In the Securities Offering Reform release, the SEC recognised that certain events, including passage of Sarbanes-Oxley, Regulation AC, revisions to the self-regulatory organisation rules governing broker-dealers, and the global research analyst settlement,¹⁶

had addressed the “veracity and reliability” of research reports, as well as other potential abuses associated with these reports.¹⁷ In particular, the SEC stated that it expects research reports “will better disclose conflicts of interest relating to research of which investors should be aware.”¹⁸ In light of these developments, the SEC decided it was “appropriate to make measured revisions to the research rules that are consistent with investor protection but that will permit dissemination of research around the time of an offering under a broader range of circumstances.”¹⁹ Rule 137 applies to broker-dealers not participating in a registered offering and therefore not classed as underwriters. In order not to violate the gun-jumping provisions and solicitation prohibitions, the broker-dealer must publish the report in the ordinary course of its business, and may not receive any consideration from, or act under any direct or indirect arrangement with, the issuer of the securities, a selling security holder, any participant in the distribution of the securities, or any other person interested in the securities. Furthermore, the issuer may not be, nor have been in the past three years: a blank cheque company,²⁰ a shell company,²¹ or a penny stock issuer.²²

Rule 138 applies to broker-dealers participating in the distribution of a different security from that being discussed in the research reports. Rule 138 permits a broker-dealer that is participating in the distribution of an issuer’s securities to publish and distribute research reports that either: relate solely to the issuer’s common stock, debt securities, or preferred stock convertible into common stock, where the offering involves solely the issuer’s non-convertible debt securities or non-convertible non-participating preferred stock; or relate solely to the issuer’s non-convertible debt securities or non-convertible, non-participating preferred stock, where the offering involves the issuer’s common stock, debt securities, or preferred stock convertible into common stock. In order to take advantage of Rule 138, the broker-dealer must regularly report on the types of securities that are the subject of the research report. The issuer involved must not be a blank cheque company, shell company or penny stock issuer and be either:

- a reporting company (foreign or domestic) and current in its Exchange Act filings; or
- a foreign private issuer that meets all of the registrant requirements of the revised Form F-3²³ (other than the reporting history provisions of General Instructions IA1 and IA2(a) to Form F-3) and either:
 - satisfies the \$75 million minimum public float threshold in General Instruction I.B.1. of Form F-3, or

- is issuing non-convertible securities other than common equity, and meets the provisions of General Instruction IB2 of Form F-3; and either:
 - has its equity securities trading on a “designated offshore securities market” as defined in Rule 902(b) of the Securities Act, and has had them trading for at least 12 months, or
 - has a worldwide public float of \$700 million or more.

Rule 139 applies to broker-dealers participating in the registered distribution of the same security as that discussed in their disseminated research reports. The broker-dealer must publish or distribute research reports in the regular course of its business, and such publication or distribution cannot represent either the initiation of publication or the re-initiation of publication. The issuer may not be a blank cheque, shell or penny stock issuer, and must:

- have filed all required Exchange Act reports during the preceding 12 months;
- meet all the registrant requirements of the revised Form S-3/F-3 (other than the reporting history provisions of General Instructions IA1 and IA2(a) to Form F-3), and either:
 - satisfies the minimum public float threshold in General Instruction IB1 of Forms S-3/F-3,
 - is or will be offering non-convertible securities other than common equity and meet the threshold pursuant to General Instruction IB2 of Form S-3/F-3,²⁴ or is
 - a WKSI as defined in Rule 405 of the Securities Act, or
 - a foreign private issuer that satisfies the same requirements as for Rule 138.

Over time, commentators have noted that the SEC’s communications rules are outmoded and need to be revised because they have the effect of inhibiting more information from being made available to the investing public. The IPO Task Force Report recommended that the SEC expand the existing safe harbours in order to permit broker-dealers to initiate coverage and distribute research on IPO issuers without being deemed to have offered securities through the research reports, and include oral (in addition to written) communications within the scope of the safe harbours.

JOBS Act Title I changes

Recognising the contribution of research coverage to the market for emerging companies, the JOBS Act attempted to address some logistical issues relating to the diligence activities undertaken in connection with IPOs; however, it

did not supersede the Global Settlement. The JOBS Act also eliminated certain quiet period restrictions on publication of research reports in offerings by emerging growth companies.

Research reports and offers

Section 105 of the JOBS Act permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an offering of common stock under the Securities Act or has a registration statement pending, and the research report will not be deemed an offer under section 2(a)(3) of the Securities Act, even if the broker-dealer will participate or is participating in the offering. Section 105(a) of the JOBS Act defines a research report as “a 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” (our emphasis). This differs from the definition of a research report in the SRO rules and Global Settlement, where the information contained in the report must be reasonably sufficient to form the basis for an investor’s decision. Accordingly, the definition of research report for purposes of the JOBS Act would encompass nearly any written or oral communication relating to an EGC or its securities made by a broker-dealer.

Section 105(a) of the JOBS Act provides that a research report published by a broker-dealer about an EGC that is planning a public offering of common equity securities will not be considered an offer for purposes of section 2(a)(10) and section 5(c) of the Securities Act. As a result, the issuance of a written research report by a broker-dealer will not trigger a section 5 violation and would not constitute a written offer “by means of a prospectus” for purposes of potential liability under section 12(a)(2). By contrast, the JOBS Act does not provide an exemption from section 12(a)(2) liability for testing-the-waters communications under the JOBS Act, but only from section 5. Therefore, a research report would have greater protection from liability under the JOBS Act than testing-the-waters materials. Whether an oral research report may be subject to section 12(a)(2) liability is more complicated. The JOBS Act does not provide a safe harbour under section 12(a)(2) with respect to oral research reports. Consequently, an oral research report could still result in section 12(a)(2) liability if it is deemed to constitute an offer of a security. As a general matter, it is worth noting that the JOBS Act has no impact on liability under Rule 10b-5 or state anti-fraud laws.

Research participation in certain meetings

Section 105(b) prohibits any SRO and the SEC from adopting any rule or regulation that would restrict a broker-dealer from participating in certain meetings relating to EGCs. The JOBS Act also removes restrictions on who within an investment bank can arrange for communications between research analysts and prospective investors in connection with an EGC IPO, permitting investment bankers to be involved in those arrangements. Further, a research analyst would be permitted to engage in any communications with an EGC’s management when other employees of the investment bank, including the investment bankers, are present.

Under section 105(b) of the JOBS Act, an associated person of a broker-dealer, including investment banking personnel, may arrange communications between research analysts and investors. This activity would include, for example, an investment banker forwarding a list of clients to the research analyst that the analyst could, at his or her own discretion and with appropriate controls, contact. In turn, a research analyst could forward a list of potential clients it intends to communicate with to investment banking personnel as a means to facilitate scheduling. Investment bankers can also arrange, but not participate in, calls between analysts and clients. In August 22 2012, the SEC’s Division of Trading and Markets published a highly anticipated series of JOBS Act Frequently Asked Questions entitled ‘About Research Analysts and Underwriters’ (the Research Analyst FAQs) which addressed various research-related matters. In the Research Analyst FAQs, the SEC has stated that such arranging activity, without more, would not violate Finra Rule 2711 or NYSE Rule 472 although it notes that firms should be mindful of other provisions of the Exchange Act and the SRO Rules as well as the applicability of the Global Settlement.²⁵

The JOBS Act prohibits a national securities association or the SEC from maintaining rules restricting research analysts from participating in meetings with investment banking personnel and an EGC in connection with an EGC’s IPO. Before the enactment of the JOBS Act, research personnel were prohibited from attending meetings with issuer management that were also attended by investment banking personnel in connection with an IPO, including pitch meetings. Section 105(b) of the JOBS Act permits research personnel to participate in any communication with the management of an EGC concerning an IPO that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is other than as an analyst, including investment banking

personnel. The SEC has interpreted this section as primarily reflecting a Congressional intent to allow research personnel to participate in EGC management presentations with sales force personnel so that the issuer's management would not need to make separate and duplicative presentations to research personnel at a time when resources of the EGC may be limited.

The SEC stated in the Research Analyst FAQs that research personnel must limit their participation in such meetings to introducing themselves, outlining their research programme and the types of factors that they would consider in their analysis of a company, and asking follow-up questions to better understand a factual statement made by the EGC's management. In addition, after the firm is formally retained to underwrite the offering, research personnel could, for example, participate in presentations by the management of an EGC to educate a firm's sales force about the company and discuss industry trends, provide information obtained from investing customers, and communicate their views.²⁶

In their October 11 2012 amendments (which became effective retroactive to April 5 2012, the date the JOBS Act was enacted), Finra amended Rule 2711(c)(4) to conform to the provisions of the JOBS Act, specifically to provide that, while research analysts are prohibited from soliciting business for investment banking, they are not prevented from attending a pitch meeting in connection with an initial public offering of an EGC that is also attended by investment banking personnel; provided, however, that a research analyst may not engage in otherwise prohibited conduct in such meetings.²⁷

In the SEC's view, section 105(b)(2) of the JOBS Act allows a firm to avoid the ministerial burdens of organising separate and potentially duplicative meetings and presentations among an EGC's management team, investment banking personnel, and research analysts. Section 105(b)(2) did not address communications where investors are present together with company management, analysts and investment banking personnel. Therefore, the SEC has taken the view that this provision of the JOBS Act does not affect the SRO rules prohibiting analysts from participating in road shows or otherwise engaging in communications with customers about an investment banking transaction in the presence of investment bankers or the company's management. These rules apply to communications with customers and other investors and do not depend on whether analysts, investment bankers, and management are participating jointly in such communications.²⁸

The Research Analyst FAQs confirm that Regulation AC is not affected by the JOBS Act.

Quiet periods

A broker-dealer participating in an issuer's IPO is generally subject to certain blackout periods with respect to publishing of research reports about such issuer. The publication of research is prohibited in advance of the IPO and, once the IPO has priced, no research can be published until 40 days following the offering. Additionally, the publication of any research must be suspended for the 15 days before and after the release or expiration of any lock-up agreement.

The JOBS Act now prohibits any national securities association (which includes Finra) or the SEC from adopting any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public appearance with respect to the securities of an EGC within any prescribed period of time following the EGC's IPO or the expiration date of any lock-up agreement. This eliminates the traditional post-IPO quiet period for EGCs.

On October 11 2012, the SEC granted accelerated approval for amendments to the SRO rules, effective immediately, that conform to the requirements of the JOBS Act related to research analysts and research reports in certain offerings by EGCs. In addition, the amendments eliminated the quiet periods in connection with IPOs and secondary offerings of EGCs by the adoption of new Finra Rule 2711(5), which states that the lock up periods discussed in paragraphs (f)(1), (f)(2) and (f)(4) of Finra Rule 2711, "shall not apply to the publication or distribution of a research report or a public appearance following an initial public offering or secondary offering of the securities of an Emerging Growth Company" (see <http://www.sec.gov/rules/sro/finra/2012/34-68037.pdf>).

The JOBS Act also did not explicitly permit publication or distribution of a research report relating to an EGC after the expiration, termination, or waiver of a lock-up agreement or prohibit quiet periods after a follow-on offering of an EGC's securities. The adoption of the amendments to the SRO Rules have made clear that both the SEC and Finra interpret the JOBS Act to apply equally to permit publication of research reports on an EGC's securities, no matter how the lock-up period ends – by termination, expiration, or waiver – both before and after the termination, expiration, or waiver of the agreement, eliminating all quiet periods for EGCs.

Section 105(d) of the JOBS Act provides that neither an SRO nor the SEC may adopt or maintain any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public

appearance with respect to the securities of an EGC following an offering or in a period before (although notably not after) expiration of a lock-up.

The Research Analyst FAQs also clarify that the JOBS Act should be understood to apply to NYSE Rule 472 to the same extent as it applies to NASD Rule 2711. Further, the Research Analyst FAQs explain that the Staff views the prohibition on quiet period rules contained in section 105(d)(2) as applying to the quiet periods on research at the termination, waiver, modification, etc. of a lock-up agreement (in connection with an emerging growth company IPO or a follow-on offering) regardless of the means by which the lock-up period comes to a close.

Other restrictions on research

The JOBS Act does not affect or amend most of the existing rules and regulations dealing with the separation of research and investment banking, even in relation to EGCs. The JOBS Act does not address or amend Regulation AC. The JOBS Act does not directly address the Global Settlement and, as the Global Settlement is a judicial order and not an SEC or Finra rule, it is technically not affected by the enactment of the JOBS Act. It is important to remember, however, that the Global Settlement only affects the eight remaining settling firms. All other broker-dealers not party to the Global Settlement are able to take advantage of the self-effectuating provisions of the JOBS Act described above. It remains to be seen whether the settling firms will petition the court for another amendment to the Global Settlement to conform to the provisions of the JOBS Act. The JOBS Act also does not address the existing research safe harbours, and it is unclear when the SEC will amend Rules 137, 138, and 139 to address the effects of the JOBS Act. The table in Appendix A compares the actions, as they relate to research and investment banking personnel, which are permitted before and after the enactment of the JOBS Act.²⁹

The future of research

To date, following enactment of the JOBS Act, most firms have proceeded cautiously in respect of research relating to EGCs. In the United States, there has not been (given traditional restrictions on offering related communications) any history of pre-deal research. It is not clear that firms will become comfortable with pre-deal IPO research even following the JOBS Act. Firms have published research reports on EGCs that have completed their IPOs; however, generally, these research reports have been published at least 25 days following completion of the IPOs. Even firms that are not parties to the Global

Settlement have not been quick to publish research reports immediately upon completion of the IPO. Over time, as practitioners become more comfortable with the new rules, and compliance departments of investment banking firms are able to adapt to these new rules, market practice may evolve. Commentators continue to emphasise the importance of availability to retail investors of information that is contained in research reports. The experiences in recent offerings have led many to advocate for additional changes related to research reports and to calls to require that any research views shared with institutional investors or with a limited number of investors be shared more broadly. We discuss these issues further in Chapter 9.

Appendix A			
May research personnel ...	Pre-JOBS Act	Post-JOBS Act	
	All issuers	EGC	Non-EGC
publish research reports concerning the securities of an issuer immediately following its IPO or expiration of any lock-up agreement?	Prohibited	Permitted	Prohibited
publish research reports concerning issuers that are the subject of any public offering of common equity securities (even if the firm is participating in the offering)?	Prohibited	Permitted	Prohibited
participate in meetings with representatives of an issuer, attended by investment banking personnel?	Prohibited	Permitted	Prohibited
contact potential investors in an issuer's IPO?	Prohibited	Permitted	Prohibited
make public appearances concerning the securities of an issuer?	Prohibited	Permitted	Prohibited
solicit business for investment banking personnel?	Prohibited	Prohibited	Prohibited
engage in communications with potential investors in the presence of investment banking personnel?	Prohibited	Prohibited	Prohibited
share price targets and ratings with an issuer before the launch of a deal?	Prohibited	Prohibited	Prohibited
be compensated based on investment banking revenue?	Prohibited	Prohibited	Prohibited

ENDNOTES

- 1 See IPO Task Force Report, *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf, at 26.
- 2 See Global Settlement (I)(1): <http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf>; Finra Rule 2711; NYSE Rule 472.
- 3 See Global Settlement Addendum A.
- 4 A research report is defined as a written communication that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision. Securities Act Rule 137(e).
- 5 See Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933, Securities Act Release No. 33-5101, 1970 WL 10585 (November 19 1970).
- 6 See, e.g., *id.* at n.88 (“the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer ...”) (citing Securities Act Release No. 33-5180, 1971 WL 120474 (August 20 1971)).
- 7 Securities Act § 5(c), 15 USC § 77e(c).
- 8 Securities Act § 5(b), 15 USC § 77e(b).
- 9 See the definition of prospectus in Securities Act § 2(a)(10), 15 USC § 77b.
- 10 Securities Offering Reform Release, No. 33-8591, 2005, WL 1692642 (July 19 2005) (the Reform Release), at 39–40. Gun-jumping refers to the illegal solicitation of an offer before a registered offering.
- 11 Reform Release, *supra* note 10, at 16.
- 12 *Id.* at n.55. See also *id.* at 41–42.
- 13 See Securities Act § 2(3).
- 14 See Securities Act Rules 137–39.
- 15 See Securities Act Rules 139(b)–(c).
- 16 See SEC Litigation Release No. 18438 (October 31 2003).
- 17 Reform Release, *supra* note 11, at 155.
- 18 *Id.*
- 19 *Id.* at 156. Research reports issued in reliance on Rule 137, 138, or 139 continue to be subject to the antifraud provisions of the federal securities laws, including liability under section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5 of the Exchange Act.
- 20 A blank cheque company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person. Securities Act Rule 419(a)(2).
- 21 A shell corporation is a company that serves as a vehicle for business transactions without itself having any significant assets or operations. Securities Act Rule 405.
- 22 A penny stock issuer is a very small issuer of low-priced speculative securities. Since penny stocks are difficult to accurately price, there are specific SEC rules that must be satisfied before a broker-dealer can sell a penny stock, and the SEC does not allow the issuer to use certain exemptions from the registration requirements when selling their securities. Exchange Act Rule 3a51-1.
- 23 Effective as of September 2 2011, the SEC amended Form S-3 and Form F-3 by revising General Instruction IB2 to eliminate the use of credit ratings as a transaction eligibility standard and replace it with an alternative set of standards. The new standards provide that an offering of non-convertible securities is eligible to be registered on Form S-3 or Form F-3 if the issuer meets the Registrant Requirements in General Instruction IA, and either has issued at least \$1 billion of non-convertible securities in transactions registered under the Securities Act, other than equity securities, for cash during the past three years, has outstanding at least \$750 million of non-convertible securities, other than common equity, issued in primary offerings for cash registered under the Securities Act (each as measured from a date within 60 days of the filing of the registration statement); or is a wholly owned subsidiary of a WKSI.
- 24 *Id.*
- 25 See Frequently Asked Questions About Research Analysts and Underwriters (August 22 2012), *available at* <http://www.sec.gov/divisions/marketreg/tmjjobsact-researchanalystsfaq.htm> (the Research Analyst FAQs), at Question 3.
- 26 See Research Analyst FAQs, *supra* note 25, at Question 4.
- 27 See <http://www.sec.gov/rules/sro/finra/2012/34-68037.pdf>
- 28 See Research Analyst FAQs, *supra* note 25, at Question 5.
- 29 This chart originally appeared in Morrison & Foerster’s Frequently Asked Questions About Separation of Research and Investment Banking.

CHAPTER 9

Other capital formation discussions

As we noted in the Introduction, the JOBS Act was the continuation of a dialogue regarding the impact of increased regulation and increased disclosure requirements on capital formation and on the IPO process more specifically. In the months ahead, the SEC must continue to make progress with the implementation of the regulations required by the JOBS Act. It is also likely that, in addition to these rule-making initiatives, we will see additional consideration of a number of topics related to capital formation in the United States. Below, we highlight what we believe to be a few of the areas that are likely to receive substantive attention in the near future.

Accredited investor status

As discussed in Chapter 4, Title II of the JOBS Act required that the SEC implement regulations relaxing the prohibition against general solicitation and general advertising in connection with certain private offerings conducted pursuant to Rule 506 under Regulation D. The JOBS Act also required an additional measure of verification of the investor's status as an accredited investor in connection with any Rule 506 offering employing general solicitation. Investor verification was required given that for private placements where general solicitation was used it was possible for an issuer or a financial intermediary working on the issuer's behalf to contact potential investors with whom neither the issuer nor the financial adviser had a pre-existing relationship. Congresswoman Maxine Waters was the sponsor of an amendment to HR 2940 that created the requirement of reasonable steps to verify, and her language was ultimately included in section 201(a)(1) of the JOBS Act. Waters explained the rationale for her amendment as follows:

... I am concerned about the process in which accredited investors verify that they are in fact accredited. As I understand it, it is currently a self-certification process. This obviously leaves room for fraud ... If we are rolling back protections for our targeted audience of sophisticated individuals, we must take steps to ensure that those folks are in fact sophisticated.¹

Historically, in the United States, the statutory private placement exemption, or section 4(a)(2) exemption, was

available for a "private offering," which was understood to be an offering made on a limited basis to a group of investors with whom the issuer, or the issuer's agent, had a pre-existing relationship, and who were in a position to have or to obtain certain information about the issuer. An offering made under proposed Rule 506(c) would still be considered a private placement; however, it would involve an offering to investors with whom the issuer potentially had no pre-existing relationship, and who might not necessarily receive any specified information about the issuer before making their investment decision. As a result, many commentators writing to the SEC about its proposed Rule 506 rules have expressed investor protection concerns. Commentators have noted that there is enhanced opportunity for fraudulent practices where general solicitation is used. News about a potential private offering may reach investors that are not accredited investors, and the information circulated about a potential investment opportunity may contain puffery or other misstatements. As a result of these concerns, many, including SEC Commissioner Aguilar have suggested that the SEC should revisit the definition of accredited investor and consider whether the definition sufficiently identifies investors that have the requisite financial sophistication to fend for themselves and not have the protections associated with registered securities offerings.²

Recent changes to the definition of accredited investor

On December 21 2011, the SEC amended the accredited investor standards in its rules under the Securities Act to implement section 413(a) of the Dodd-Frank Act.³ The change to the net worth standard was effective upon enactment by operation of the Dodd-Frank Act on July 21 2010; however, section 413(a) also required the SEC to revise its Securities Act rules to conform to the new standard.⁴ Rules 215⁵ and 501(a)(5)⁶ under the Securities Act set forth the accredited investor standards.⁷ Pursuant to section 413(a) of the Dodd-Frank Act, the SEC is required to adjust the net worth standard for natural persons individually or jointly with their spouse, to "more than \$1,000,000 ... excluding the value of the primary

residence.”⁸ Before the adoption of section 413(a), the standard under Rules 215 and 501(a)(5) required a minimum net worth of more than \$1 million, but permitted an individual investor and his or her spouse to include the net equity value of their primary residence in calculating whether they qualified for accredited investor status.⁹

In amending Rules 215 and 501(a)(5) to conform to the new standard under the Dodd-Frank Act, the SEC adopted identical language in the two rules,¹⁰ defining individual accredited investor status to require net worth in excess of \$1 million, provided that “[t]he person’s primary residence shall not be included as an asset.” The final accredited investor definition is consistent with the approach taken in the proposing release with respect to the basic treatment of the primary residence and indebtedness secured by the primary residence.¹¹ The final rules also provide a specific provision addressing the treatment of incremental debt secured by the primary residence that is incurred in the 60 days before the sale of securities to the individual in the exempt offering and certain new grandfather provisions.

The new standard discusses the treatment of mortgage debt in calculating net worth. “Indebtedness that is secured by the person’s primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability ...”¹² Thus, under the final rules, as in the proposing release, net worth is calculated by excluding positive equity an investor may have in its primary residence.¹³ The SEC believed this approach to be the most appropriate way to conform its rules to section 413(a) stating: “it reduces the net worth measure by the net amount that the primary residence contributed to net worth before enactment of section 413(a), which we believe is what is commonly meant by ‘the value of a person’s primary residence’.”¹⁴ The final rules also provide that any excess of indebtedness secured by the primary residence over the estimated fair market value of the residence is considered a liability for purposes of determining accredited investor status on the basis of net worth, whether or not the lender can seek repayment from other assets in default.¹⁵ In the SEC’s view, the full amount of the debt incurred by the investor is the most appropriate value to use in determining accredited investor status.¹⁶

Continuing review and mandatory study

Section 413(b) of the Dodd-Frank Act provides that four years after enactment, and every four years thereafter, the SEC must review the accredited investor definition as applied to natural persons, including adjusting the

threshold, although it may not be lowered below \$1 million.¹⁷ Section 415 of the Dodd-Frank Act requires the Comptroller General of the United States to conduct a Study and Report on Accredited Investors examining “the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.”¹⁸ The study is expected to be taken into account by the SEC in future rulemakings in this area.¹⁹ On July 18 2013, the US Government Accountability Office (GAO), which is headed by the Comptroller General, released its report with respect to the accredited investor standard.²⁰ In addition to reviewing data in order to understand whether the existing criteria serves the intended purpose or whether alternative criteria should be considered, the GAO conducted interviews with market participants. In connection with its study, the GAO considered whether there should be an investments owned criterion added to the accredited investor standard, or a tiered approach that would limit investments to a fixed percentage of an individual’s net worth (similar to the proposed investment limits for crowdfunding offerings under Title III of the JOBS Act). The GAO also considered whether the accredited investor standard should be modified to introduce a sophistication or financial literacy prong. In its report, the GAO notes that market participants seemed to consider a minimum investments owned criterion as practicable.

Proposed revisions of the accredited investor standard

These recent changes to the accredited investor standard did not fundamentally alter the basic premise of the definition – that is, net worth continues to be used as a proxy for financial sophistication, or, at least for the ability to bear a certain measure of investment risk. The commentators writing to the SEC in connection with the Rule 506 rulemaking have noted that perhaps the net worth test has outlived its usefulness and that other standards should be considered that might better identify a category of investors not needing the protections afforded in connection with registered securities offerings. For example, the Investment Company Institute in its comment letter stated:

We firmly believe that the income and net worth tests in the definition of accredited investor no longer serves their intended purpose: to identify a universe of individual investors that can fend for themselves and do not need the protections of the securities laws. There is no question that the income and net worth tests have substantially eroded since 1982, when they were established.

Others have cited greater concerns in connection with offerings using general solicitation conducted by private funds or hedge funds, and have suggested that the SEC consider a separate sophistication standard for offerings by private funds. Yet another group of commentators has observed that the level of financial literacy remains remarkably low. In fact, the SEC published a study on financial literacy, mandated by section 917 of the Dodd-Frank Act, which found that retail investors in the United States lack basic financial literacy.²¹

The SEC has recently stated that the permitted use of general solicitation in Rule 506(c) offerings provides an opportune time for thoroughly reexamining the accredited investor definition, given that it was the condition that only accredited investors would be permitted to purchase the securities offered through a general solicitation that gave many members of Congress the comfort needed to support the elimination of the decades-old ban on general solicitation.²² The SEC's goal in reviewing the accredited investor definition, as mandated by Dodd-Frank Act section 413(b), is to determine whether the current net worth and income tests for a natural person still identify persons who can bear the economic risk of an investment in securities sold outside of the Securities Act registration process and can afford a complete loss of such investment if necessary.²³ The SEC has stated that it will look into whether other suggested criteria can serve either as an alternative or supplemental test for accredited investor status, which include the following:

- possession of professional certifications or degrees, such as a CFA, CPA, or a securities licence, which some believe may provide an individual with the knowledge and sophistication needed to be an accredited investor, presumably irrespective of the person's financial wherewithal;
- ownership of a specific amount of investment securities, which some believe provides a better measure of a person's ability to make informed decisions about whether or not to purchase securities; and
- reliance on intermediaries such as a registered broker or an investment adviser whose involvement could potentially enhance a person's ability to make an investment decision.²⁴

The SEC will also consider carefully the potential economic consequences of using any alternative or supplemental criteria, including whether the criteria will significantly expand or diminish the potential pool of accredited investors.²⁵ The SEC has stated that any action that it ultimately takes will strike a careful balance between the need to facilitate capital formation and the need to maintain a robust level of investor protection.²⁶

In light of the considerable debate regarding the appropriate balance between facilitating capital formation and protecting investors, it is reasonable to expect that the accredited investor standard will be revised soon.

Large accredited investors

In August 2007, the SEC proposed a variety of changes relating to private placements, some of which were adopted. In those proposals, the SEC had considered creating a new exemption (Rule 507) from the registration provisions of the Securities Act for offers and sales of securities to "large accredited investors" pursuant to the general exemptive authority provided in section 28 of the Securities Act that would permit an issuer to publish a limited announcement of the offering. In addition, the proposals incorporated a definition of large accredited investor based on the accredited investor definition, but with higher and somewhat different dollar amount thresholds, and would have made changes such that legal entities considered accredited investors if their assets exceed \$5 million would be required to have \$10 million in investments to qualify as large accredited investors; that individuals generally would be required to own \$2.5 million in investments or have an annual income of \$400,000 (\$600,000 with a spouse) in order to qualify as large accredited investors, compared to the current accredited investor standard of \$1 million in net worth or an annual income of \$200,000 (\$300,000 with a spouse). Large accredited investors that participated in exempt offerings would be considered qualified purchasers under section 18(b)(3) of the Securities Act, thereby resulting in covered security status and the pre-emption of certain state securities regulation. The SEC proposal also included adding an alternative investments-owned standard for determining accredited investor and large accredited investor status. Ultimately, these provisions of the 2007 proposals were not adopted; however, there is reason to believe that consideration of the Rule 506 rulemaking may lead to re-evaluation of these measures.

Content standards and filing requirements

The Rule 506 rule proposals also have led to suggestions from commentators that for Rule 506 offerings relying on general solicitation the SEC should consider the appropriateness of imposing content standards on the materials used in the sales process. Some commentators note that issuers and financial intermediaries should be required to include disclaimers or warning labels on the materials that are used to market Rule 506 offerings using general solicitation. Currently, there are no specified information requirements in connection with traditional

Rule 506 offerings. There are, however, certain required disclosures contemplated in the context of crowdfunded offerings. Other commentators note that special requirements should be imposed in the context of Rule 506 offerings by private funds. The Investment Company Institute, for example, advocated in its letter that the SEC impose content restrictions on private fund advertising, prohibit performance advertising by private funds until regulations are promulgated that would standardise requirements for performance information, and require Finra review of the materials used in connection with these offerings. Others have suggested that the SEC consider requiring issuers to file or submit the materials used in connection with their general solicitation so that the SEC can study the types of information used for this purpose.

Offering-related communications

In the Introduction, we reviewed an exchange of correspondence in 2011 between Congressman Darrell Issa and SEC chairman Schapiro relating to, among other things, capital formation. In those 2011 letters, Issa questioned whether the SEC's regulations relating to offering related communications had a chilling effect on capital formation. The SEC committed to review its rules relating to offering related communications. The Issa-Schapiro dialogue had a second act in mid-2012. In June, Issa wrote a letter to Schapiro inquiring about the regulatory structure applicable to IPOs.²⁷ The letter specifically address "barriers to communicating with investors" during the IPO process. Issa referenced public reports that noted that during the Facebook IPO certain of the underwriters may have provided institutional investors with information about revenue forecasts for Facebook, and questioned whether SEC regulations relating to offering communications had the effect of creating information disparities. Issa also questioned whether there were sufficient safe harbours for research reports such that research analysts would be encouraged to make reports available broadly, including to retail investors. This was not the first time that concerns had been raised regarding the dissemination of information in IPOs. Going as far back as 2003, a committee convened by the New York Stock Exchange and the NASD at the SEC's request, referred to as the IPO Advisory Committee, published a report that made a number of recommendations that were designed to restore investor confidence in IPOs.²⁸ The IPO Advisory Committee report included a section on levelling the playing field that suggested that issuers be required to make a version of their IPO roadshow available publicly on an unrestricted basis; and that underwriters disclose final IPO allocations to issuers. In her response letter dated June

19 2012, Schapiro reiterated the SEC's views that the statutory prospectus should be the primary source of information for investors, but referred to various communications reforms, including Securities Offering Reform in 2005, which had relaxed restrictions on communications.²⁹ Schapiro also recognised the importance of research reports and observed that the SEC had modernised the safe harbours for research reports. As we discuss in Chapter 8, the JOBS Act provides greater flexibility to publish research reports relating to EGCs. As Schapiro noted in her letter, however, despite that greater flexibility, investment banks may choose not to disseminate broadly their research and may provide different research products to different types of investors. The SEC does not mandate that research reports be made publicly available. Moreover, although the SEC has liberalised offering communications and underwriters have the opportunity to use "underwriter" free-writing prospectuses in order to make available supplemental information about an issuer or the offered securities, in practice, these are rarely used.

Issa's letter also inquired whether there should be broader safe harbours to address the inclusion of forward-looking information and projections in prospectuses and in free-writing prospectuses, and asked the SEC to consider whether additional safe harbours should be adopted to protect communications, including forecasts, made in research reports. Schapiro noted the existence of safe harbours for certain forward-looking communications. She also pointed out that liability would not extend to a research analyst's failure to predict accurately an issuer's future performance.

This most recent Issa-Schapiro exchange makes for interesting reading, and may be the beginning of a broader discussion related to offering communications, and a further levelling of the playing field as between retail and institutional investors. We would anticipate that the SEC will continue to consider the regulations applicable to offering communications.

The structure of IPOs

The Issa letter to Schapiro also raises some fundamental questions regarding the structure of IPOs in the United States, where the book building process has long been relied upon for public offerings. As part of the book building process, underwriters will meet with institutional investors and the issuer and the underwriter will conduct a road show that will include in-person meetings with groups of institutional investors. During the marketing process, the underwriters will gather informal indications of interest from institutional investors about the extent of

their interest in an investment in the issuer's securities, and their pricing sensitivities. Over the marketing period, the underwriters begin to form a book of interest based on these conversations.

Issa questions whether this traditional book building approach allows the underwriters to exercise too much discretion over the IPO process, and questions whether the approach may be fraught with conflicts that may lead to inaccurate pricing. Issa cites to the experience of the Facebook IPO. He also wonders whether the process has the effect of foreclosing opportunities for meaningful retail participation in IPOs. Finally, Issa asks the SEC to comment on whether it has considered whether alternatives, such as auction-based pricing, would be more beneficial and potentially less subject to overpricing and conflicts of interest. Again, this is another area that had been explored many times before Issa's letter. The IPO Advisory Committee in 2003 considered whether alternatives to the book building approach should be advanced. In other jurisdictions, there are examples of modified book building approaches, where specified percentages are reserved for retail investor orders, as well as examples of auction-based approaches. Academics have devoted substantial attention to considering whether book building or auction-based approaches are beneficial to issuers and investors. In fact, Schapiro in her response to Issa provides a very thorough survey of the leading academic literature on IPO underpricing and the advantages and disadvantages associated with the book building and the auction-based models. More or less at the same time, the US Senate Banking Committee's Subcommittee on Securities, Insurance and Investment held hearings examining the IPO process. Legislators had as their objective considering whether the IPO process is fair and transparent, and whether the IPO market operates effectively for both institutional and retail investors. Dr Ann Sherman provided testimony regarding the IPO methods used in different countries and commented on the costs and benefits of various approaches, concluding that retail investors are unlikely to contribute to more accurate IPO pricing. Sherman and other participants in the hearing did conclude that there was unequal access to information regarding IPOs. Sherman suggested requiring issuers to make their road show materials publicly available. Others suggested extending the application of Regulation FD in order to make certain that retail investors had access to the same information that was provided to institutional investors.

It is likely that academics, legislators and the SEC will continue to consider changes in the IPO process in the near future.

Disclosure requirements

The JOBS Act's IPO on-ramp provisions attempt to streamline the disclosure requirements for EGCs undertaking an IPO; however, as we discuss in Chapter 1, in practice, market participants have been reluctant to take full advantage of certain of these benefits. The SEC also was mandated by Title I of the JOBS Act to undertake a study of the disclosure requirements set forth in Regulation S-K in order to analyse current registration requirements and determine whether these requirements can be updated, modified or simplified in order to reduce costs and other burdens on EGCs. On December 23 2013, the SEC delivered to Congress its report, which considers potential recommendations for revisiting disclosure requirements in a broad manner, although it notes that further information gathering and review is warranted in order to formulate specific recommendations regarding specific disclosure requirements.³⁰ Many practitioners have noted that even with the scaled disclosure requirements applicable to smaller reporting companies and the disclosure accommodations made available to EGCs by the JOBS Act, the SEC disclosure requirements and disclosure practices still seem to result in incredibly detailed and lengthy IPO documents that are often hundreds of pages long. Commentators have noted that, for a retail investor, it may be difficult to wade through dense disclosures, and to assess which risks are most critical to the issuer's future prospectus and business results. For this reason, some commentators have encouraged the SEC to review whether certain disclosure requirements may be modernised or simplified.

In various speeches following the December 2013 release of the JOBS Act-mandated Regulation S-K study, SEC representatives have discussed the SEC's continuing review of disclosure requirements and reiterated the need for disclosure reform.³¹ The SEC has described the plan for its review, which will be undertaken by various teams across the Division of Corporation Finance, will focus on specific sections of Regulation S-K and S-X, and will assess whether certain requirements are outdated, whether certain requirements result in redundant or duplicative disclosures and whether disclosure requirements might benefit from a principles-based approach.³² The SEC's review will first begin by considering the disclosures included in periodic reports and will evaluate whether Industry Guides and form specific disclosures should be updated, taking into consideration whether disclosure requirements should be scaled for smaller reporting companies and EGCs.³³

The SEC has stated that it plans to consider how information is disclosed and whether disclosure

documents could be made simpler and more user friendly through the introduction of hyperlinks or topical indices.³⁴ The SEC staff also intends to consider whether to recommend a “company disclosure” or “core disclosure” approach in which an issuer’s basic business description and other company information would be disclosed in a “core” document and supplemented through periodic filings.³⁵ In the absence of rule changes, the SEC has noted that practitioners could improve disclosures by avoiding repetition, producing more tailored, less generic risk factors and other disclosures, and eliminating outdated information.³⁶

The SEC also has identified a number of areas that often lead to duplicative disclosures.³⁷ For example, discussion of share-based compensation, verbatim repetition from the notes to the financial statements in the MD&A section of an issuer’s critical accounting policies, and the “follow the leader” phenomenon whereby issuers include disclosures made by other comparable companies in their own filings even if those disclosures may not be appropriate or as relevant.³⁸

The in-betweeners

As we have noted elsewhere, over time, the SEC has done much to modernise its regulations relating to offering communications, and also has adopted changes to improve the capital formation process. Securities Offering Reform in 2005 simplified the offering process for the largest and most sophisticated public companies, WKSIs, and provided these companies with greater flexibility for offering related communications. Companies that are considered smaller reporting companies are entitled to rely on certain scaled disclosure requirements. Now, EGCs may elect to take advantage of the IPO on-ramp disclosure accommodations. Many mid-sized companies cannot benefit from EGC status (due to the timing of their initial offerings of equity securities) and are larger than smaller reporting companies and not entitled to scaled disclosure provisions. We refer to these companies as in-betweeners. Their disclosure and reporting concerns have not been addressed. In addition, these companies have capital-raising needs that also have not been addressed by Securities Offering Reform or by the modifications made to the eligibility requirements for use of shelf registration statements for primary offerings. We anticipate that the SEC will continue to evaluate the need to address capital formation issues, and will consider making appropriate adjustments to existing regulations for these issuers.

Capital formation issues for smaller companies continues to be a topic of discussion among market participants. For example, an industry task force, the

Equity Formation Task Force, recently issued a report to the US Treasury Department recommending a few additional measures to facilitate capital formation.³⁹ The Equity Formation Task Force appears to be a successor to the IPO Task Force whose October 2011 report to the US Treasury Department contained various recommendations that were eventually incorporated in the JOBS Act.⁴⁰ The report of the Equity Formation Task Force repeats a number of recommendations made by other industry groups, such as calling for the SEC to propose a framework for section 3(b)(2) offerings and a pilot program on wider tick sizes.⁴¹

Information requirements and continuing reporting requirements

In the post-JOBS Act world, there may be some disparities in the information requirements that arise for an issuer depending on the securities offering exemption that the issuer chooses to rely on in connection with its capital-raising efforts. For example, following enactment of the JOBS Act, an issuer may conduct a Rule 506 offering using general solicitation and make sales to investors that are verified to be accredited investors. The issuer is not subject to any information requirements. The securities sold in a Rule 506 offering will be covered securities. The securities also will be restricted securities. Conceivably, an issuer could conduct multiple Rule 506 offerings, and, if the issuer remains below the holder-of-record threshold, the issuer would remain exempt from any requirement to provide information to security-holders. By contrast, an issuer might choose to raise modest amounts of capital in crowd-funded offerings through a funding portal or a broker-dealer made to a broader universe of potential investors, provided that the issuer complies with certain limited information requirements and thereafter makes publicly available certain limited information. The securities sold in a crowd-funded offering will be restricted securities. Title IV of the JOBS Act contemplates that an issuer that is not an SEC-reporting company may rely on the new section 3(b)(2) exemption to offer securities publicly, which will not be restricted securities, provided that the issuer satisfies certain information requirements. Following a section 3(b)(2) offering, the issuer may choose to remain private although it will have issued shares in a broad-based offering, and may be subject to certain SEC reporting requirements, although these are likely to be limited. In addition, given the growth of private secondary markets, the securities of a private company may be actively traded through the facilities of a private secondary market and, provided the issuer remains under the holder-of-record threshold, it will not be subject to information

requirements. There also may be issuers that have securities that trade on the Pink Sheets and there may not necessarily be robust publicly available disclosures for investors. It is likely that this is an area on which the SEC will focus as part of its investor protection mission.

Current state of the US IPO market

Two years have passed since the JOBS Act was signed into law to ease regulatory burdens on smaller companies and facilitate public and private capital formation. The provisions related to IPOs, which have been effective since enactment, seek to encourage EGCs to pursue an IPO by codifying a number of changes to the IPO process and establishing a transitional “on-ramp” that provides for scaled-down public disclosures for EGCs. Although the US IPO market was stronger in 2013 than any year since 2000, both in terms of the number of IPOs and capital raised,⁴² most commenters agree that the JOBS Act itself has had little impact on the increased volume of IPO activity, which instead is attributable to the broader recovery of the US economy since the financial crisis. The impact of the JOBS Act on the execution of IPOs, however, has been significant, resulting in new market practices that issuers and their advisors should be aware of when planning an IPO.⁴³

In 2013, a total of 222 IPOs generated \$54.9 billion in gross proceeds. This is a significant increase compared to 2012, when 128 IPOs generated \$42.7 billion (\$26.9 billion, excluding Facebook), and 2011, when 125 IPOs generated \$36.3 billion. The IPO market continues to be dominated by EGCs, which accounted for approximately 80% of all IPOs in 2013, representing an increase from 75% of all post-JOBS Act IPOs in 2012. Measured by total proceeds raised, the energy, financial and healthcare segments were the most active in 2013; however, the resurgence of the IPO market generally was broad-based. Financial sponsors also continue to play an important role in the IPO market. In 2013, a total of 70 private equity-backed IPOs generated \$24.8 billion and 81 venture capital-backed IPOs generated \$9.6 billion, which, measured by the number of deals, represented a multi-year high. In 2013, the average IPO generated an average total return of 35%, which outpaced the 2013 performance of benchmark indices and represented a significant increase from the 21% total return in 2012. Returns were driven by average first-day gains of 17% and average aftermarket gains of 15%, up from 14% and 6%, respectively, in 2012.

The US IPO market is off to an even stronger start in 2014 compared to 2013.⁴⁴ The first quarter of 2014 showed more activity than any other first quarter since 2000, as 64 companies raised \$10.6 billion and 103 new

IPOs were filed, which is more than double the number of IPOs in the first quarter of 2013. The number of IPOs in the first quarter of 2014 led to a 39% increase in proceeds raised over the first quarter in 2013, as investors sought out growth companies in a continued low interest rate environment. Almost half (30) of all IPOs in the first quarter were health care companies, with biotechnology companies comprising the largest portion (26). The technology sector also played a large role with 14 companies going public, most of which focused on enterprise software, though a late-quarter sell off among growth stocks impacted the IPO space as well. With 40 venture capital-backed IPOs and 16 private equity-backed IPOs, sponsors continue to play an important part in the US IPO market. The average IPO return was approximately 25% in the first quarter of 2014, which is higher than the average IPO return and the performance of benchmark indices for the first quarter of 2013. While there is some caution in the market regarding overly optimistic valuations, causing a sell-off in growth stocks that has carried on into April 2013, with 122 companies in the IPO pipeline, including 103 new filings in the first quarter worth an estimated total of \$32.3 billion in proceeds, the outlook suggests that 2014 could be even more active than 2013.

JOBS Act 2.0

Having just passed the second anniversary of the JOBS Act, it seems that more regulatory change may be under consideration, which market participants must continue to monitor. In fact, various bills have been introduced in the House of Representatives recently to address parts of the existing JOBS Act framework, which some have referred to as JOBS Act 2.0, which we describe briefly below.

On March 14 2014, the House Financial Services Committee approved two bills, HR 3623 and HR 4164. HR 3623, titled the Improving Access to Capital for Emerging Growth Companies Act, was introduced by Stephen Fincher (R-TN). HR 3623 builds on the successes of Title I of the JOBS Act, which created the EGC issuer class. HR 3623 reduces burdensome SEC registration and disclosure requirements to help EGCs access the capital markets more efficiently, streamline the IPO process and allow EGCs to deploy their assets to grow and create jobs. Most significantly, HR 3623 would reduce the 21-day period (during which a confidential submission must be made public) to 15 days. HR 4164, titled the Small Company Disclosure Simplification Act, was introduced by Robert Hunt (R-VA) and provides a voluntary exemption for all EGCs and other issuers with annual gross revenues under \$250 million from the SEC’s onerous

requirements to file their financial statements in an interactive data format known as eXtensible Business Reporting Language (XBRL). HR 4164 requires the SEC to conduct a cost-benefit analysis on the XBRL requirement and report to Congress within one year after enactment. HR 4164 also allows small companies to spend more time focusing on expanding and creating jobs rather than on redundant SEC compliance requirements.

On April 9 2014, the House Financial Services Committee held a hearing on a group of proposed bills that would make additional changes to bolster capital formation and reduce disclosure requirements for smaller companies and EGCs, including the following:

- Amending the definition of “non-accelerated filer”;
- Simplifying the annual report on Form 10-K through the addition of a “summary” page;
- Mandating that the SEC simplify and modernize Regulation S-K’s disclosure requirements;
- Increasing the dollar threshold for issuances under Rule 701 under the Securities Act;
- Revising the definition of WKSI so that more issuers benefit from the flexibility permitted to these issuers;
- Shortening the holding period under Rule 144 under the Securities Act;
- Amending Form S-1 to permit smaller reporting companies to forward incorporate reports filed with the SEC; and
- Amending Form S-3 for smaller reporting companies to eliminate the current one-third restriction on primary offerings.⁴⁵

On May 1 2014, the House Financial Services Committee held a hearing on additional proposed bills to help smaller companies and EGCs.⁴⁶ One of the bills addresses the crowdfunding framework and would have the effect of striking Title III of the JOBS Act and reverting to the House version of the crowdfunding title in most respects. Another bill addresses certain issues raised by the SEC’s proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act, with the goal of encouraging the use of general solicitation in Rule 506(c) offerings. Most significantly, a bill titled the Startup Capital Modernization Act of 2014 would address the pre-emption of state blue sky laws in Tier 2 Regulation A offerings, clarifying that Congress intended Tier 2 Regulation A offerings not be subject to state blue sky review. In addition, the bill addresses various other aspects of the proposed Regulation A rules, including the Exchange Act reporting threshold, and would codify the “Section 4 1-1/2” exemption for private resales of restricted securities.

Going forward

Given that the SEC still must undertake significant rulemaking in order to comply with the mandate of the JOBS Act, it would be premature to make any assessments regarding the impact that the JOBS Act has had (or will have) on capital formation in the United States. It is not too early, however, to conclude that it has been a catalyst for important discussions regarding the appropriate balance between regulation and disclosure requirements and efficient access to the capital markets. We hope that the lively dialogue that the JOBS Act has reignited will continue as it will lead to innovation and interesting and worthwhile emerging companies being given an opportunity to reach the public markets.

ENDNOTES

1. House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises Holds Markup on HR 1965, HR 2167, HR 2930, HR 2940 and a Draft Bill Concerning Small Companies and Regulatory Relief, 112th Cong., 1st Sess. (Congressional Hearing held October 5 2011), Congressional Quarterly Transcripts at 8-9.
2. *See, e.g.*, Commissioner Luis Aguilar’s statements titled “Increasing the Vulnerability of Investors,” *available at* <http://www.sec.gov/news/speech/2012/spch082912la.htm>.
3. Net Worth Standard for Accredited Investors, Securities Act Release No. 9287, Investment Company Act Release No. 29891, 2011 WL 6415435 (December 21 2011) (the Net Worth Standard Adopting Release).
4. On January 25 2011, the SEC proposed amendments to the accredited investor standards. *See* Net Worth Standard for Accredited Investors, Securities Act Release No. 9177, Investment Company Act Release No. 29572, 2011 WL 231559 (January 25 2011).
5. 17 CFR § 230.215.
6. 17 CFR § 230.501(a)(5).
7. Rule 501 defines the term “accredited investor” for purposes of exempt and limited offerings under Rules 504, 505 and 506 of Regulation D. Rule 215 defines the term “accredited investor” under section 2(a)(15) of the Securities Act, setting the standards for accredited investor status under section 4(5) of the Securities Act, formerly section 4(6), which permits offerings solely to accredited investors of up to \$5 million, subject to certain conditions. 15 USC 77d(5). Former section 4(6) of the Securities Act was renumbered section 4(5) by section 944 of the Dodd-Frank Act.
8. Section 413(a) of the Dodd-Frank Act, Pub. L. No. 111-203, § 413(a) (2010), states: “The Commission shall adjust any net worth standard for an accredited investor, as set forth in the rules of the Commission under the Securities Act of 1933, so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than \$1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person, except that during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be \$1,000,000, excluding the value of the primary residence of such natural person.”
9. *See* 17 CFR § 230.215(e) and § 230.501(a)(5) (2010).
10. The SEC stated: “... so the two rules will implement Section 413(a) of the Dodd-Frank Act in the same way.” *See* Net Worth Standard Adopting Release at *4.
11. *See id.* at *5.
12. *See* Rule 501(a)(5)(i)(B) (as amended).
13. *Id.*
14. *Id.*
15. *See id.* at *7.
16. *Id.* The SEC further explained: “that is the basis on which interest accrues under the mortgage and the amount that third parties would look to in assessing creditworthiness.” *Id.*
17. Dodd-Frank Act § 413(b).
18. Dodd-Frank Act § 415.
19. *See* Net Worth Standard Adopting Release at *3.
20. *See* Report to Congressional Committees titled “Securities and Exchange Commission - Alternative Criteria for Qualifying as an Accredited Investor Should be Considered” (July 2013), *available at* <http://gao.gov/assets/660/655963.pdf>.
21. *See* study at <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>.
22. *See* speech of Keith F. Higgins, Director, Division of Corporation Finance, titled “Keynote Address at the 2014 Angel Capital Association Summit” (March 28 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541320533#.U2PsBBnD-Hs>.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. Letter dated June 19 2012 is *available at* <http://s3.documentcloud.org/documents/370607/issa-ipoletter-june2012.pdf>.
28. *See* <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p010373.pdf>.

29. See letter at <http://online.wsj.com/public/resources/documents/se-cipoletter0826.pdf>.
30. For more information regarding the SEC's study on Regulation S-K, see "Required studies – Regulation S-K" in Chapter 1 (The IPO on-ramp).
31. See e.g., speech of Keith F. Higgins, Director, Division of Corporation Finance, titled "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting" (April 11 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541479332#.U2fpdxnD-Hs.>; speech of Keith F. Higgins, Director, Division of Corporation Finance, titled "Keynote Address at PLI – Thirteenth Annual Institute on Securities Regulation in Europe" (March 20 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541190424#.U2f0ARnD-Hs.>; speech of Chair Mary Jo White, titled "Chairman's Address at SEC Speaks 2014" (February 21 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.U2f6IxnD-Hs.>; speech of Chair Mary Jo White, titled "The SEC in 2014" (January 27 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540677500#.U2f7JhnD-Hs.>
32. See speech of Keith F. Higgins, Director, Division of Corporation Finance, titled "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting" (April 11 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541479332#.U2fpdxnD-Hs.>
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. See speech of Keith F. Higgins, Director, Division of Corporation Finance, titled "Keynote Address at PLI – Thirteenth Annual Institute on Securities Regulation in Europe" (March 20 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541190424#.U2f0ARnD-Hs.>
38. *Id.*
39. See report titled "From the On-Ramp to the Freeway: Refueling Job Creation and Growth by Reconnecting Investors with Small-Cap Companies" (November 11 2013), available at <http://www.equitycapitalformationtaskforce.com/files/ECF%20From%20the%20On-Ramp%20to%20the%20Freeway%20vF.pdf>.
40. For more information regarding the IPO Task Force, see "Legislative and other efforts" in Introduction.
41. *Id.*
42. Renaissance Capital, US IPO Market, 2013 Annual Review (January 2 2014) (2013 Annual Review). All historical annual IPO performance data is derived from the 2013 Annual Review.
43. For more information, see "Market trends relating to JOBS Act accommodations" in Chapter 2 (The IPO process).
44. Renaissance Capital, US IPO Market, Q1 2014 Quarterly Review (March 31 2014) (Q1 2014 Quarterly Review). All historical quarterly IPO performance data is derived from the 2013 Quarterly Review.
45. For more information regarding the hearing and the proposed bills, see <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=375104>.
46. For more information regarding the hearing and the proposed bills, see <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=377434>.

APPENDIX A: JOBS ACT: SUMMARY OVERVIEW

EMERGING GROWTH COMPANIES (EGCS)	
Qualifying as an EGC	EGC defined as an issuer with total gross revenues of less than \$1 billion
Disqualification as an EGC	EGC until the earliest of: (A) last day of the fiscal year during which issuer's total gross revenues exceed \$1 billion; or (B) five years from IPO; or (C) the date on which issuer has sold more than \$1 billion in non-convertible debt; or (D) date on which issuer becomes a large accelerated filer (public float of \$750 million)
IPOs by EGCs	<ul style="list-style-type: none"> Confidential submission available Must file publicly at least 21 days before roadshow Two years audited financials required (instead of three) May elect to rely on certain scaled disclosures available to smaller public reporting companies (such as for executive compensation) May engage in testing the waters with QIBs and IAs
Ongoing disclosures/governance requirements	<ul style="list-style-type: none"> May opt into voluntary disclosures Subject to phase-in for say-on-pay and say-on-golden parachute requirements Subject to phase-in for any PCAOB mandatory rotation or modified audit report requirement Exempt from section 404(b) attestation (but subject to requirement for management assessment of internal control requirement over financial reporting and to CEO/CFO certification requirement) Not required to adopt FASB standards until broadly applicable to private companies
RESEARCH REPORTS	
Permitted communications	<ul style="list-style-type: none"> Research report on EGC not an offer Research report on EGC not subject to quiet period or lock-up period restrictions Distribution participants may publish research before commencement of an offering, during an offering, or post offering
Conflicts, separation, disclosures	<ul style="list-style-type: none"> Reports subject to required conflicts disclosures and certifications Modifies separation/chaperoning requirements in connection with certain activities for EGCs
REGULATION D	
Rule 506 offerings	General advertising/general solicitation permitted provided that the issuer verifies purchasers are all AIs
BROKER-DEALER REGISTRATION	
Platforms/matching services	Not required to register as broker-dealers solely as a result of participation or involvement in Rule 506 offerings that use general solicitation or general advertisement, provided that platform does not receive transaction-based compensation, handle customer funds or securities, or participate in documentation
CROWDFUNDING	
Offering threshold	The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is not more than \$1 million

Investment threshold	The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed: <ul style="list-style-type: none"> the greater of \$2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; or 10% of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000
Manner of offering	Transaction must be conducted through a broker or funding portal
Information	Information filed and provided to investors regarding the issuer and offering, including financial information based on the target amount offered
Funding portals	Funding portals will be subject to SEC and SRO regulation
Liability	Subject to section 12(a)(2) liability
Status of securities	Covered securities for NSMIA
Other conditions	Issuers must file with the SEC and provide to investors, no less than annually, reports of the results of operations and financial statements of the issuers as the SEC may prescribe
REGULATION A+/3(B)(2) EXEMPTION	
Eligible issuer	Non-reporting issuer with principal place of business in Canada or the United States; not an investment company or a bad actor
Offering threshold	<i>As proposed:</i> Tier 1 offerings: Up to \$5 million within the prior 12-month period (with no more than \$1.5 million sold on behalf of selling stockholders) Tier 2 offerings: Up to \$50 million within the prior 12-month period (with no more than \$15 million sold on behalf of selling stockholders) SEC required to review threshold and report on threshold to Congress
Status of securities	Covered securities for NSMIA if either: <ul style="list-style-type: none"> listed/traded on a securities exchange; or sold to a qualified purchaser
Liability	Subject to section 12(a)(2) liability
Other conditions	<i>As proposed:</i> SEC empowered to impose additional conditions; Tier 2 issuers must include audited financial statements in the offering statement and file with the SEC annual audited financial statements
EXCHANGE ACT THRESHOLD	
Issuer not a bank or bank holding company	Becomes subject to reporting within 120 days after last day of fiscal year ended in which issuer had: <ul style="list-style-type: none"> total assets in excess of \$10 million; and a class of equity securities (other than exempted securities) held of record by either 2,000 persons, or 500 persons not AIs

Issuer is a bank or bank holding company	Becomes subject to reporting within 120 days after last day of fiscal year ended in which issuer had: <ul style="list-style-type: none"> • total assets in excess of \$10 million; and • a class of equity securities (other than exempted securities) held of record by 2,000 persons May deregister if class of equity securities held of record by fewer than 1,200 persons
Held of record	Excludes: securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from section 5 registration requirements and securities sold pursuant to crowdfunding exemption
REQUIRED STUDIES	
Decimatisation	SEC, within 90 days of enactment, must report to Congress on its study of the impact of decimatisation on IPOs and the impact of this change on liquidity for EGCs; SEC also must consider within 180 days of enactment any recommendations regarding the minimum trading increments for EGCs; on July 20 2012, the SEC delivered to Congress its report
Regulation S-K	SEC, within 180 days of enactment, must report to Congress on its review of Regulation S-K and its recommendations concerning changes to Regulation S-K requirements for EGCs to simplify burdens; on December 23 2013, the SEC delivered to Congress its report
Blue Sky laws and Regulation A	Comptroller General, within 3 months of enactment, must report to Congress on its study of the impact of blue sky laws on Regulation A offerings; on July 3 2012, the Comptroller General delivered to Congress its report
Section 12 SEC enforcement authority	SEC, within 120 days of enactment, must report to Congress on its assessment regarding additional enforcement tools that may be needed for it to enforce anti-evasion provision in section 12(b)(3); on October 16 2012, the SEC delivered to Congress its report

This chart first appeared in a Morrison & Foerster publication

APPENDIX B: COMPARISON OF US SECURITIES EXEMPTIONS

Type of Offering	Dollar Limit	Manner of Offering	Issuer and Investor Requirements	Filing Requirement	Information Requirements	Restriction on Resale	Blue Sky Exemption	SEC Review
Section 3(a)(11)	None.	No limitation other than to maintain intrastate character of offering.	All issuers and investors must be resident in state. No limitation on number.	None.	None.	Rests within the state (generally a one-year period for resales within state).	Need to comply with state blue sky laws by registration or state exemption.	None.
Section 4(a)(2)	None.	No general solicitation or general advertising.	All issuers and investors must meet sophistication and access to information test so as not to need protection of registration.	None.	None.	Restricted securities.	Need to comply with state blue sky laws by registration or state exemption.	None.
Rule 504 Regulation D	\$1 million within prior 12 months.	No general solicitation or general advertising unless registered in a state requiring use of a substantive disclosure document or sold under state exemption for sales to accredited investors with general solicitation.	No requirements.	File Form D with the SEC not later than 15 days after first sale. Filing not a condition of the exemption.	None.	Restricted unless registered in a state requiring use of a substantive disclosure document or sold under state exemption for accredited investors with general solicitation.	Need to comply with state blue sky laws by registration or state exemption.	None.
Rule 505 Regulation D	\$5 million within prior 12 months.	No general solicitation or advertising.	Unlimited accredited investors and 35 non-accredited investors.	File Form D with the SEC not later than 15 days after first sale. Filing not a condition of the exemption.	None.	Restricted securities.	Need to comply with state blue sky laws by registration or state exemption.	None.

Type of Offering	Dollar Limit	Manner of Offering	Issuer and Investor Requirements	Filing Requirement	Information Requirements	Restriction on Resale	Blue Sky Exemption	SEC Review
Rule 506(b) Regulation D	None.	No general solicitation or advertising permitted.	Unlimited accredited investors and 35 non-accredited investors.	File Form D with SEC not later than 15 days after first sale. Filing not a condition of the exemption.	<p>If purchased solely by accredited investors; none.</p> <p>If purchased by non-accredited investors:</p> <ol style="list-style-type: none"> 1. Non-reporting companies under the Exchange Act must furnish the same kind of information as in a registered offering, or in a Regulation A offering if eligible, but with somewhat modified financial statement requirements; 2. Reporting companies must furnish (i) specified Exchange Act documents or (ii) information contained in the most recent specified Exchange Act report or Securities Act registration statement on specific forms, plus, in any case, (iii) updating information and limited additional information about the offering; <ol style="list-style-type: none"> a. Issuers must make available before sale; b. Exhibits; c. Written information given to accredited investors; d. Opportunity to ask questions and receive answers; 3. Issuers must advise purchasers of the limitations on resale. 	Restricted securities.	Need to comply with state blue sky laws by registration or state exemption.	None.

Type of Offering	Dollar Limit	Manner of Offering	Issuer and Investor Requirements	Filing Requirement	Information Requirements	Restriction on Resale	Blue Sky Exemption	SEC Review
Rule 506(c) Regulation D	None.	General solicitation and general advertising permitted.	All purchasers must be accredited investors. No requirements for issuer; following offering issuer must make current information available.	File Form D with SEC not later than 15 days after first sale. Filing not a condition of the exemption.	None.	Restricted securities.	Need to comply with state blue sky laws by registration or state exemption.	None.
Rule 144A	No limit.	General solicitation permitted, provided that securities are sold only to persons that the seller (or someone acting on the seller's behalf) reasonably believes is a QIB.	Investors must be QIBs. No limitation on number.	None.	None; however market practice generally requires preparation of an offering memorandum that contains information similar to that contained in a registered offering, although somewhat abbreviated, or such information may be incorporated by reference if it is publicly available.	Restricted securities.	Need to comply with state blue sky laws by registration or state exemption.	None.

Type of Offering	Dollar Limit	Manner of Offering	Issuer and Investor Requirements	Filing Requirement	Information Requirements	Restriction on Resale	Blue Sky Exemption	SEC Review
Section 4(a)(6)	\$1 million within prior 12 months.	General solicitation permitted only through an intermediary (a funding portal or broker-dealer). Issuers are prohibited from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker-dealer.	<p>Eligible issuer. No investor requirement; however, investors are subject to an investment limit:</p> <ul style="list-style-type: none"> The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the section 4(a)(6) exemption during the 12-month period preceding the date of the transaction, does not exceed: <ul style="list-style-type: none"> the greater of \$2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; or 10% of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more 	File Form C with the SEC. Issuer subject to annual filing obligation.	Issuers must provide to investors and intermediaries information about the issuer (including financial statements, which would be reviewed or audited depending on the size of the target offering amount), its officers, directors, and greater than 20% shareholders, the ownership and capital structure of the issuer and risks relating to the issuer and the offering, as well specific offering information such as the use of proceeds for the offering, the target amount for the offering, the deadline to reach the target offering amount, and regular updates regarding progress toward reaching the target, and such other information that the SEC will require.	Securities are subject to transfer restrictions for one year following the purchase, subject to certain exceptions.	No need to comply with state blue sky laws.	None.

Type of Offering	Dollar Limit	Manner of Offering	Issuer and Investor Requirements	Filing Requirement	Information Requirements	Restriction on Resale	Blue Sky Exemption	SEC Review
Tier 1 Regulation A	\$5 million within prior 12 months, but no more than \$1.5 million by selling security holders.	"Testing the waters" permitted before filing Form 1-A. Sales permitted after Form 1-A qualified.	Eligible issuer. No investor requirement.	File test-the-waters documents, Form 1-A, any sales material and report of sales and use of proceeds with the SEC.	Disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related party transactions; a description of the offered securities; and two years of financial statements. Audited financial statements would be required only to the extent they were prepared for other purposes.	None; freely resalable.	Need to comply with state blue sky laws.	Subject to SEC review.
Tier 2 Regulation A	\$50 million within the prior 12 months, but no more than \$15 million by selling security holders.	"Testing the waters" permitted before filing Form 1-A. Sales permitted after Form 1-A qualified.	Eligible issuer. No investor requirement; however, investors are subject to an investment limit: Investors required to limit purchases to the greater of 10% of the investor's net worth or annual income.	File test-the-waters documents, Form 1-A, any sales material and report of sales and use of proceeds with the SEC. Issuer subject to ongoing reporting requirements.	Disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related party transactions; a description of the offered securities; and two years of financial statements. Audited financial statements are required.	None; freely resalable.	No need to comply with state blue sky laws for offerings to "qualified purchasers."	Subject to SEC review.

APPENDIX C: EGC IPO PROCESS

