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IPO On-Ramp: The Emerging Growth Company

By Bonnie J. Roe

The JOBS Act springs from a belief that smaller companies are the engines of economic growth and job creation. In this view, the decline of the smaller company IPO market over the last decade threatens the long-term prospects of the American economy, as smaller companies that cannot access the IPO market must either rely on private capital to finance their growth or sell themselves to larger companies.

In an effort to restore vibrancy to the smaller company IPO market, the JOBS Act eases disclosure and other regulatory requirements for smaller companies in the initial public offering process and in subsequent public reporting. The belief is that, over the past decade, smaller companies have been discouraged from entering public markets for capital due to the cost of regulatory compliance, particularly in the wake of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. If we create a new "on-ramp" to public markets by easing the regulatory burden for smaller companies, the thinking goes, more of these companies will seek to go public.

In order to have a successful public capital market for smaller companies, however, analysts and investors have to come to the party as well. In this regard, the JOBS Act includes "test the waters" provisions to permit smaller companies to approach institutional investors prior to and during the offering period. More controversially, the JOBS Act includes provisions relaxing restrictions on communications by analysts during the offering period.

Emerging Growth Companies Defined

The JOBS Act creates a new category of issuer—the "emerging growth company"—that will benefit from a lighter level of regulation in the offering process and as a reporting company for a period of up to five years from the date of the issuer's first public offering. An emerging growth company is an issuer that:

- had less than $1 billion in annual gross revenues during its most recently completed fiscal year;
- made its first sale of "common equity securities" pursuant to an effective registration statement within the last five years (or has not yet made a registered sale of common equity securities);
- has not issued more than $1 billion in non-convertible debt securities over the past three years; and
- is not a "large accelerated filer" as defined in Rule 12b-2 under the Securities Exchange Act of 1934 (i.e., a seasoned issuer with at least $700 million in common equity market capitalization held by non-affiliates).

Companies that made their first sale of common equity securities in a registered offering on or before December 8, 2011, are excluded from the definition of emerging growth companies. The goal of the emerging growth company on-ramp, after all, is to create new public companies, not to assist those that were already public when the JOBS Act was conceived. Companies that are reporting companies as a result of Section 12(g) under the Exchange Act and have not issued shares in a registered offering under the Securities Act of 1933, and companies that have publicly issued debt but not equity, might nonetheless qualify as emerging growth companies under the JOBS Act definition.

The $1 billion revenue ceiling for emerging growth companies is significant, as a large number of companies seeking to go public are likely to have revenues of less than that amount.

On April 16, 2012, and May 3, 2012, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) posted "frequently asked questions" relating to emerging growth companies on the SEC website, indicating among other things that foreign issuers are eligible to be treated as emerging growth companies so long as they otherwise meet the requirements.

Financial Disclosures and Reporting Requirements

The JOBS Act seeks to make the financial reporting process easier and less expensive for emerging growth companies in several ways, reflecting the fact that the public company accounting requirements and accounting costs often are a substantial deterrent to going public.

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Number of Years of Financial Statements
The JOBS Act limits the number of years of audited financial statements that must be included in the initial registration statement of an emerging growth company to two years (rather than the usual two years of audited balance sheets and three years of audited statements of income and changes in financial position). In presenting selected financial data in accordance with Item 301 of Regulation S-K in a registration statement or periodic reports (which requires five years of financial data), an emerging growth company need not present financial data for any year prior to which it has provided audited financial information in its initial registration statement. The emerging growth company's management's discussion and analysis of financial condition and results of operations, or MD&A, need not discuss information for years prior to which the emerging growth company has provided audited financial information in its initial registration statement.

Rolling Back the Clock on Unpopular Reforms
The JOBS Act also tackles several recent and unpopular requirements and proposals relating to the financial reporting process: auditor attestation of internal controls reporting; auditor rotation and reports; and compliance with new accounting requirements that are not required of non-reporting companies.

Auditor Attestation. One regulatory requirement about which companies frequently complain is auditor attestation of the company's internal controls report. This requirement, which came into law under Section 404(b) of the Sarbanes-Oxley Act, can result in significant accounting expenses that can be particularly onerous for a smaller company. In response to concerns about the cost of complying with Section 404(b), the SEC now exempts all "smaller reporting companies" (generally those with a common equity market capitalization of less than $75 million held by non-affiliates) from auditor attestation, and all companies are exempt from the auditor attestation requirements for the first year following the effective date of the registration statement for their initial public offering. The JOBS Act extends this exemption from auditor attestation to all emerging growth companies. While this might seem to be a relatively small change, it is the item that is most likely to produce significant savings. Like smaller reporting companies and newly public companies, emerging growth companies are still required to provide officer certifications of the company's internal control of financial reporting.

Auditor Rotation and Reports. The JOBS Act also exempts emerging growth companies from any future requirement of the Public Company Accounting Oversight Board (PCAOB) that reporting companies be subject to mandatory auditing firm rotation. Again this may appear to be a relatively small item, particularly because the PCAOB has proposed for discussion but not yet adopted such a requirement. If auditor rotation is adopted in the future, however, the exemption from this requirement could prove to be a significant benefit, as the process of selecting and engaging a new auditor can be a difficult and expensive one for smaller companies. Emerging growth companies are also exempted from any future requirement that auditors provide additional information about the audit and financial statements of the company in an auditor's discussion and analysis.

New Accounting Principles. Finally, the JOBS Act exempts emerging growth companies from compliance with new accounting principles that are adopted by the PCAOB after the date of the JOBS Act enactment, if the new principles are not applicable to non-reporting companies. This responds to a concern of many smaller companies that they do not have adequate resources to keep up with frequent and costly accounting changes.

The exemption from new accounting principles comes with a significant caveat. While in general an emerging growth company is free to choose on an ad hoc basis whether or not to make use of the exemptions available to it, an emerging growth company must either opt in, or opt out, of the exemption from new accounting principles on a one-time basis. If the emerging growth company wishes to comply with a new accounting standard, it must comply with all new accounting standards and notify the SEC of such choice.

Executive Compensation Disclosure and Say-On-Pay

The JOBS Act exempts emerging growth companies from the requirement for a shareholder advisory vote on executive compensation (Say-On-Pay) and the frequency of Say-On-Pay voting. Emerging growth companies are also exempt from "Say-On-Golden Parachute" shareholder advisory voting requirements. In addition, emerging growth companies need not comply with SEC rules yet to be adopted under Dodd-Frank requiring disclosure of the relationship of the CEO's pay to the median pay for company employees.

The executive compensation disclosures of emerging growth companies may follow the generally lighter requirements applicable to smaller reporting companies, rather than the full-fledged requirements applicable to larger companies. Significantly, this means that emerging growth companies need not provide a compensation discussion and analysis, may present compensation data for fewer named executive officers, and may omit some of the tables required for other companies.

The JOBS Act directs the SEC to conduct a review of Regulation S-K to determine how it can be "updated to modernize and simplify" the registration process and the burdens of disclosure for emerging growth companies. A report on this review is to be sent to Congress by October 2, 2012.

Testing the Waters and Confidential Review

Investor interest in an initial public offering is often difficult to gauge. Companies are understandably reluctant to commit to the expensive and time-consuming process of preparing and filing a registration statement, and waiting for SEC staff comments, without knowing whether in-

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vestors will be interested. Frequently companies identify a potential problem and need feedback as to whether it is indeed a "show-stopper" for investors or the SEC. Market windows appear and disappear quite suddenly. Smaller companies may find the resulting uncertainties particularly vexing because they are unfamiliar with the market and the regulatory process, or they may face barriers created by lack of funds or management time.

Some uncertainties, of course, can be resolved by getting good professional advice from investment bankers, attorneys, or accountants, but there may well be issues that cannot be resolved through such advice or a call to the SEC staff. The JOBS Act provides two mechanisms, available solely to emerging growth companies, designed to address uncertainties, preserve flexibility, and facilitate feedback, one from investors and the other from the SEC.

Testing the Waters and (Non-)Integration

The JOBS Act amends Section 5 of the Securities Act to permit emerging growth companies to "test the waters" with certain types of investors prior to or after filing a registration statement with the SEC. Specifically, emerging growth companies and brokers or other persons authorized to act on their behalf may engage in oral or written communications with potential investors that are "qualified institutional buyers," or "QIBs," as defined in Rule 144A under the Securities Act, or institutions that are accredited investors, as defined in Rule 501 under the Securities Act, to determine whether such investors might have an interest in the contemplated securities offering. Communications with such investors can be made informally and will not violate Section 5 as gun-jumping or the use of an illegal prospectus, so long as the company complies with the prospectus delivery requirements at or prior to the time of sale in the registered offering.

The testing-the-waters provision (new Section 5(d) of the Securities Act) permits an emerging growth company that had not yet filed a registration statement to approach institutional investors about a potential offering and then determine whether to accomplish such offering as a private placement under Rule 506 under the Securities Act, or to offer securities publicly, without worrying about the potential integration of public and private offerings. By contrast, if the emerging growth company has already filed a registration statement when it tests the waters and then decides to accomplish the offering as a private placement, it might be required to withdraw the registration statement and consider, under the circumstances (and given the types of investors in the private offering), whether a waiting period is required to avoid integration of the contemplated private offering with the abandoned public offering. As other provisions of the JOBS Act have directed the SEC to remove restrictions on general solicitation in an offering under Rule 506 where all investors are accredited investors (see "The JOBS Act: Easing Exempt Offering Restrictions"), the emerging growth company might not need to worry about integration in this scenario

Confidential Review of Registration Statements

In the case of an initial public offering, the JOBS Act permits an emerging growth company to submit a draft registration statement to the SEC for nonpublic review by the SEC staff, provided that the initial draft submission and all amendments thereto are publicly filed with the SEC on EDGAR not later than 21 days before the date that the company conducts its road show. A company might want confidential treatment for business reasons—it might not want to announce to competitors or others that it was pursuing the possibility of a public offering until that offering was more certain to take place—and it might wish to keep its business and financial information confidential until then. If the company were to abandon its plans to go public before embarking on a road show, presumably the registration statement would never become publicly available on the SEC website and the company's financial and other information disclosed in the confidentially submitted draft would remain confidential.

On April 10, 2012, the SEC's Division of Corporation Finance posted "frequently asked questions" about the process surrounding the confidential submission of registration statements. The SEC noted that the drafts should be substantially complete and should include a signed audit opinion, but need not include the auditor's consent. When a registration statement is actually filed, the prior confidential draft submissions will be filed as an exhibit to the registration statement. The confidential filing procedure is not available for registration statements on Form 10 under the Exchange Act.

Communications by Analysts

Smaller public companies are often stock market orphans, with little or no analyst coverage and typically less investor interest as a result. The investment banking firms that specialized in smaller company IPOs in the 1990s have in many cases been acquired by larger firms less interested in this market.

The JOBS Act aims to restore analyst and investment banking firm interest in smaller company public capital markets by:

- enabling analysts to provide research on an emerging growth company during its offering period, even if the analysts' firms are participating in, or will participate in, the offering, without classifying such research as an "offer" with resulting liability under the Securities Act;
- eliminating restrictions based on functional role relating to which associated persons of a broker, dealer or member of a national securities association may arrange for communications between a securities analyst and prospective investors in an emerging growth company;
- permitting an analyst to be "brought over the wall" to communicate with management and members of the investment banking team working with management on the offering of an emerging growth company; and

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- prohibiting regulatory restrictions by the SEC or any national securities association on the provision of research within any prescribed period of time following the public offering date of an emerging growth company or before and after the release of any lock-up period imposed by the underwriting agreement, restricting sales by the emerging growth company or its shareholders.

These provisions rescind pre-JOBS Act law that required investment banking firms participating in an IPO to refrain from publishing research in advance of an IPO or within 40 days following the completion of the offering or 15 days before and after the release or expiration of any lock-up period imposed pursuant to the underwriting agreement. These JOBS Act provisions also remove restrictions designed to preserve analyst independence and assure that analysts are not used to solicit investment banking business.

It is unclear whether investment banking firms will take advantage of the latitude granted under the JOBS Act, or whether the scope of the provisions can or will be effectively narrowed by regulatory action of the SEC or the self-regulatory organizations. Despite the apparent latitude granted by the JOBS Act, investment banking firms must still consider the possibility of liability under Rule 10b-5 under the Exchange Act for research published by their analysts in the period before and after the offering.

Tick Size

Some studies have claimed that decimalization of the stock market (i.e., quoting and trading in increments of one penny) caused brokerage firms to retreat from this market as the profits that they could make on the spread between bid and asked prices was diminished. In response to this concern, the JOBS Act requires the SEC to conduct a study of the impact of decimalization on the number of initial public offerings and liquidity for small and mid-cap company securities. The JOBS Act empowers the SEC (not later than October 2, 2012) to designate a minimum increment greater than one cent but less than 10 cents for emerging growth companies for use in all quotations and trading.

Conclusion

The relief granted to emerging growth companies became effective with the enactment of the JOBS Act on April 5, 2012. Whether there will be a rush to market depends on many factors, including the willingness of underwriters to embrace the new rules, the appetite of investors, and general market conditions. Other provisions of the JOBS Act—such as the elimination of the prohibition on general solicitation for offerings to accredited investors under Rule 506 and to qualified institutional buyers in Rule 144A offerings (see "The JOBS Act: Easing Exempt Offering Restrictions"), or the introduction of crowdfunding (see "Crowdfunding: Its Practical Effect May Be Unclear Until SEC Rulemaking is Complete")—may prove more appealing to some issuers and investors. Nevertheless, the desire to make it easier for companies to go public in the United States and to scale regulation appropriately to both foster capital-raising and ensure investor protection are worthy goals. Time will tell how effective the JOBS Act provisions are in achieving these goals and whether the stated objective, the creation of jobs, will result.

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