Insights Skadden

Excerpted from *2014 Insights*. The complete publication is available at www.skadden.com.

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A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

The JOBS Act: The Resurgent IPO Market and What We Learned in Year Two

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Almost two years have passed since the Jumpstart Our Business Startups Act (the JOBS Act) was signed into law to ease regulatory burdens on smaller companies and facilitate public and private capital formation.[1] The provisions related to IPOs, which have been effective since enactment, seek to encourage companies with less than $1 billion in annual revenues, or emerging growth companies (EGCs),[2] 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 U.S. IPO market was stronger in 2013 than any year since 2000, both in terms of the number of IPOs and capital raised,[3] most commenters agree that the JOBS Act itself has had little impact on the increased volume of IPO activity. Its impact 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.

A Stronger IPO Market

In 2013, a total of 222 IPOs generated $54.9 billion in gross proceeds, 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 percent of all IPOs in 2013, representing an increase from 75 percent of all post-JOBS Act IPOs in 2012. Measured by total proceeds raised, the energy, financial and health care 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 percent, which outpaced the 2013 performance of benchmark indices and represented a significant increase from the 21 percent average total return in 2012. Returns were driven by average first-day gains of 17 percent and average after-market gains of 15 percent, up from 14 percent and 6 percent, respectively, in 2012.

Given the cautious optimism in the markets (even in the face of the recent decision by the U.S. Federal Reserve to begin tapering its asset purchase program) and the general willingness of investors to pursue higher yielding assets in the current low interest rate and low volatility environment, we believe the IPO market will remain strong in 2014.

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[1] *See Skadden Corporate Finance Alert*: 'Jumpstart Our Business Startup Act' Signed Into Law" (Apr. 5, 2012), *available at* http://www.skadden.com/insights/corporate-finance-alert-jumpstart-our-business-startups-act-signed-law.

[2] An EGC is defined as an issuer (including a foreign private issuer) with total annual gross revenues of less than $1 billion during its most recently completed fiscal year.

[3] Renaissance Capital, *US IPO Market, 2013 Annual Review*, December 18, 2013 (2013 Annual Review). All historical IPO performance data herein is derived from the 2013 Annual Review, which includes IPOs with a market capitalization of at least $50 million and excludes closed-end funds and SPACs, as of December 18, 2013.

Reforms to the IPO Process

In an effort to remove some of the traditional obstacles in the IPO process, the JOBS Act codified a number of substantive and procedural reforms, which have become an established part of the EGC "playbook." Using data from the final prospectuses of approximately 175 EGCs that successfully completed underwritten IPOs between April 5, 2012, and December 18, 2013, with gross proceeds of at least $75 million, below is a summary of a number of current market practices for EGC IPOs and related practical commentary, including certain interpretative guidance issued by the staff of the U.S. Securities and Exchange Commission (Staff and SEC, respectively).

Confidential Submission of Draft Registration Statements

An EGC may submit its IPO registration statement confidentially in draft form for Staff review, provided that the initial confidential submission and all amendments are publicly filed with the SEC not later than 21 days prior to the EGC's commencement of its roadshow. The confidential submission process permits an EGC to commence the SEC review process without publicly disclosing sensitive strategic, proprietary and financial information. Further, 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.

Continued Strong Acceptance of Confidential Submission Process. Approximately 87 percent of EGC IPOs consummated in 2013 availed themselves of the confidential submission process, compared to approximately 70 percent of post-JOBS Act EGC IPOs consummated in 2012. In both years, a majority chose to submit two draft registration statements before making their first public filing.

While the decision to take advantage of the confidential submission process always should be made based on the particular facts and circumstances an EGC faces, we believe that market practice will continue to trend strongly in favor of confidential submissions. Some EGCs, however, may determine not to avail themselves of the confidential submission process. For example, we continue to see a number of EGCs that forego the confidential submission process based on the belief that a public filing would help attract bidders in the case of a "dual-track" IPO/M&A process.

Practice Points

- **Substantially Complete.** The registration statement and prospectus must be substantially complete when submitted to the SEC, including a signed audit report. However, because it is not deemed "filed" under the Securities Act, a draft registration statement need not be signed by the company or by any of its executive officers and directors, nor must it include an auditor's consent.
- **Mechanics of Making a Confidential Submission to the SEC.** All draft registration statements and amendments to draft registration statements must be submitted via Edgar using the new submission form types DRS and DRS/A. An EGC need not pay any registration fee at the time of the confidential submission.

> An EGC will not be subject to Sarbanes-Oxley until the registration statement is publicly filed.

- **FINRA Filing Requirements and Fees.** The FINRA filing requirements and related fees are triggered when the EGC names any of its underwriters. The FINRA filing will not be available to the general public.
- **Sarbanes-Oxley.** An EGC will not be subject to Sarbanes-Oxley, including the prohibition on personal loans to directors and executive officers, until the registration statement is publicly filed.
- **Press Releases.** An EGC may issue a press release that publicly announces the confidential submission of the registration statement provided the press release complies with limitations imposed by Rule 135 to avoid gun-jumping issues.[4] The recent IPO by Twitter included a much discussed Rule 135-compliant "tweet" that announced the confidential submission of the draft registration statement; however, to date, most EGCs have not issued press releases announcing a confidential submission.
- **Inadvertently Commencing the Roadshow in Connection With Internal Sales Force Presentations.** Confidentially submitted registration statements have to be filed publicly at least 21 days before an EGC conducts its roadshow. The Staff has provided informal guidance that it does not view internal sales force presentations as commencing the roadshow so long as the sales force does not make outbound calls on that date and the net roadshow has not been activated.

Reduced Financial Statements and Selected Financial Data

An EGC may present two years of audited financial statements in its IPO registration statement, compared to the three years required for a non-EGC. An EGC also may limit the number of years of selected financial data to two years.[5]

Increasing But Still Mixed Acceptance. Approximately 56 percent of EGC IPOs that were consummated in 2013 elected not to take advantage of the ability to include reduced financial disclosures and, instead, included three years of audited financial statements in their prospectus. Of the EGCs that elected to include three years of audited financial statements, slightly more than half included three years of selected financial data. EGCs that elected to provide only two years of audited financial statements typically included only two years of selected financial data. This contrasts with 2012, where approximately 75 percent of EGC IPOs included three years of audited financial statements, and most included five years of selected financial data.

Where three years of audited financial statements are included in the prospectus, EGCs and their advisors continue to cite the extra year of audited financial statements as necessary to show investors the longer-term trends and historical growth trajectory of the company, which may have a positive impact on marketing the offering as well as satisfy liability concerns. Where an EGC includes only two years of audited financial statements in the prospectus, the decision most often is tied to a determination that the extra year of financial statements is not necessary to understand the EGC's "story," *e.g.*, the EGC is a life sciences company that will not be valued based on historical

[4] Rule 135 permits an issuer to discuss the "anticipated timing of the offering." Thus, so long as the confidential submission is noted narrowly in the context of the timing of the offering, the press release will comply with Rule 135 (assuming the conditions of the rule are otherwise satisfied).

[5] Title I FAQs, at Question 11.

financial performance or is a development stage company with little operating history during the third year. We believe that each of these trends likely will continue, although the ultimate decision to include reduced financial disclosures will be company- and transaction-specific.

Practice Points

- **Abbreviated Financial Statements of Acquired Businesses and Equity Method Investees.** An EGC registration statement that is required to present only two years of audited financial statements also may limit the audited financial statements of acquired businesses and equity method investees under Regulation S-X to two years.[6]

Testing-the-Waters Communications

The JOBS Act significantly eases the Section 5 restrictions on gun-jumping by permitting an EGC, or a person authorized to act on the EGC's behalf, to make oral and written offers to qualified institutional buyers (QIBs) and institutional accredited investors before or after the filing of a registration statement to gauge their interest in the offering.

Increasing But Still Mixed Acceptance. The frequency and degree to which EGCs or their authorized representatives have conducted testing-the-waters communications is not readily apparent from SEC filings, because these communications do not need to be publicly filed with the SEC. Although overall use of these communications remains largely deal-specific, in our experience, they are increasing.

Market practices related to testing-the-waters communications are best understood if the communications are separated into general "meet the management" presentations and presentations exploring valuation. "Meet the management" presentations between EGCs and underwriter-selected QIBs, which in certain cases precede any confidential submission, are an increasingly accepted practice. The substance of these meetings generally focuses on explaining the EGC's "story," with a view toward assisting the EGC in determining whether to proceed with an IPO. Financial statements and performance-related information generally are not part of the presentation unless the deal team is comfortable that the presentation materials will conform to the prospectus, and there is no discussion of valuation or solicitation of nonbinding indications of interest.

Presentations exploring valuation, on the other hand, have been used, albeit not frequently and typically on a post-filing basis, to explore valuation for EGCs that had a "story" or were a part of an industry that was the subject of heightened interest from investors. Not surprisingly, the timing of these more substantive discussions continues to be heavily influenced by buy-side interest. Companies should note that many underwriters prefer to schedule these testing-the-waters meetings, if at all, only after the draft registration statement has been through at least one (and preferably two) rounds of Staff review in an effort to ensure that the content of the communications will conform to the prospectus.

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[6] *Id.* at Question 16. Question 45 expands this guidance to an EGC business combination registration statement, and provides that an EGC that is not a shell company and includes only two years of audited financials in its business combination registration statement needs to present only two years of audited financial statements of a (non-smaller reporting) target company notwithstanding its significance. *Id.* at Question 45.

In the case of either "meet the management" presentations or presentations exploring valuation, consideration must be given to the launch date of the offering, as some investors continue to balk at entertaining a testing-the-waters meeting close in time to the actual roadshow. However, as a general matter, the robust IPO market appears to have reduced buy-side complaints of investor fatigue resulting from the devotion of limited resources to testing-the-waters presentations.

We expect practices will continue to evolve in this area — though cautiously and incrementally — and likely will be influenced materially by the strength of the IPO markets.

Practice Points

- **Liability.** Given that the JOBS Act does not exempt issuers and underwriters from potential anti-fraud liability for any oral or written testing-the-waters communications, EGCs and their authorized personnel generally should follow the same procedures and protocols in these communications as for a roadshow (*e.g.*, conforming the communications to the statutory prospectus disclosure and generally avoiding the use of projections). EGCs should not treat a testing-the-waters presentation as a "mock" roadshow; rather, management should be prepared to deliver a final and refined pitch.
- **SEC Comments.** Although a testing-the-waters communication does not need to be filed with the SEC, EGCs should continue to expect to receive a standard comment from the Staff requesting that any "written materials" used in connection with testing-the-waters communications (even if taken back after a presentation) be provided supplementally to the Staff in connection with its review of the registration statement. The Staff will analyze these materials primarily with a view to ensuring consistency between any testing-the-waters communications and the prospectus. Because of the prospect of having to include these materials in the prospectus, EGCs and underwriters sometimes prefer oral presentations. If written materials are used, consider providing the materials to the Staff on a supplemental basis and requesting that the materials be returned or destroyed as contemplated by Securities Act Rule 418(b). Issuers also should consider including a separate back-up request for confidential treatment under Rule 83 of the SEC's Rules on Information and Requests, in case the Staff does not agree that the return or destruction of the documents is appropriate under the circumstances.
- **Use of a "Pink Herring" Prospectus.** In connection with certain testing-the-waters meetings, some EGCs have posted a password-protected version of the confidential registration statement on the Internet roadshow and disabled the print option. These precautions are intended to ensure that the EGC is not deemed to be using a non-compliant prospectus in violation of Section 5, which requires that a valid preliminary prospectus be publicly filed and include a bona fide price range.
- **Representations/Indemnification.** As with free writing prospectuses, EGCs continue to be asked to make representations to the underwriters with respect to the information contained in testing-the-waters materials and to indemnify the underwriters for any damages arising from material misstatements in or omissions from the materials.
- **Gauging Investor Interest Versus Soliciting Orders.** In August 2012, the Staff addressed the impact on testing-the-waters communications of the limitations under Exchange Act Rule 15c2-8(e), which requires a broker-dealer to provide a

customer a preliminary prospectus prior to any solicitation of orders. The Staff guidance confirmed that Rule 15c2-8(e) applies only after the filing of a registration statement, and clarified that underwriters may discuss price, volume and market demand and solicit nonbinding indications of interest without being considered to be improperly soliciting a customer's order.

Publication and Distribution of Research Reports

Broker-dealers may publish or distribute at any time a research report about an EGC that proposes to register an equity offering or has a registration statement covering an equity offering pending, and the research report will not be deemed an "offer" under the Securities Act, even if the broker-dealer is participating or will participate in the offering. Together with 2012 NYSE and FINRA rulemaking,[7] the JOBS Act also eliminates, for EGC IPOs, the existing FINRA-based 40-day (for managing underwriters and co-managers) and 25-day (for other syndicate members) quiet periods imposed immediately after IPOs and the 15-day (for managers and co-managers) quiet period extension imposed prior to and after the expiration, waiver or termination of a lock-up agreement. Anti-fraud liability under Exchange Act Section 10(b) and Rule 10b-5 thereunder and state law is not impacted by the JOBS Act provisions addressing the publication and distribution of research reports.

> "Underwriters continue to maintain a cautious approach to the publication and distribution of pre- and post-deal research."

Continued Mixed Acceptance. Underwriters continue to maintain a cautious approach to the publication and distribution of pre- and post-deal research, based largely on regulatory, practical and liability concerns. First, we are not aware of any participating underwriters publishing research before or during an IPO by an EGC. Second, as it relates to post-deal research, under-writers continue to abide by a "best practices" consensus that research should be published no earlier than 25 days after the date of the EGC IPO, so as not to compete with the IPO prospectus during the prospectus delivery period. In the near-term, we expect little change in market practices related to current pre- and post-deal research reports.

Practice Points

- **Elimination of Research Quiet Periods Not Related to an IPO.** Underwriters are taking advantage of the elimination of the research quiet periods to publish research following an EGC secondary or follow-on offering and/or during the 15 days prior to or following the expiration, waiver or termination of a lock-up agreement.

Streamlined or Exempt Disclosures

EGCs continue to move aggressively to take advantage of many accommodations under the JOBS Act, including the eligibility to make scaled disclosures or rely on exemptive relief from certain disclosure and other requirements for up to five years following their IPOs. The EGC may elect to forego reliance on any disclosure accommodation or exemption available to it.

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[7] *See Skadden Corporate Finance Alert:* "FINRA Amendments Adopted to Implement JOBS Act Changes," (Oct. 2012), *available at* http://www.skadden.com/insights/corporate-finance-alert-finra-amendments-adopted-implement-jobs-act-changes. The liberalization of analyst participation in pitch meetings for IPOs by EGCs is beyond the scope of this article.

Limited Executive Compensation Disclosures

EGCs are permitted to provide scaled executive compensation disclosure under the requirements generally available to smaller reporting companies. Accordingly, and counter to the disclosures otherwise required by Item 402 of Regulation S-K, an EGC may (i) omit the detailed Compensation Discussion and Analysis (CD&A), (ii) 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 (iii) omit four of the six executive compensation tables required for larger companies.

Continued Strong Acceptance. Approximately 80 percent of EGC IPOs consummated in 2013 that otherwise would be required to include traditional executive compensation disclosures (*i.e.*, excluding offerings by foreign private issuers, externally managed REITs, commodity pools, etc.) elected to take advantage of the reduced disclosure. The majority of these EGCs took full advantage of the accommodation and omitted the CD&A section and included only a Summary Compensation Table and Outstanding Equity Awards Table covering three rather than five named executive officers and limited the tabular disclosures to two years. This largely aligns with 2012, where approximately 75 percent of the qualifying EGC IPOs commenced after mid-April 2012 elected to take advantage of the reduced executive compensation disclosure, and a majority took full advantage of the accommodation.

Practice Points

- **Abbreviated CD&A.** In our experience, most investors continue to be primarily interested in the historical executive compensation data. To the extent they desire an analysis and discussion of a company's executive compensation disclosures, these investors typically are more interested in a forward-looking discussion of the company's executive compensation philosophy and practices as a newly public company rather than the executive compensation decisions made while a private company. Absent special circumstances, however, the inclusion of an abbreviated CD&A generally is not necessary to successfully market an EGC IPO.

> "Most investors continue to be primarily interested in a company's historical executive compensation data."

Auditor Attestation Report Under Section 404(b) of Sarbanes-Oxley

EGCs are exempt from the requirements under Section 404(b) of Sarbanes-Oxley to have an auditor attest to the quality and reliability of the company's internal control over financial reporting. The exemption remains valid for so long as the company retains its EGC status. The practical effect of this exemption is to extend relief already available to almost all newly public companies. That is, under SEC rules, all 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.

Continued Strong Acceptance. Virtually all EGCs dating to the enactment of the JOBS Act have included disclosure that they intend to, or may, take advantage of the exemption from providing the auditor attestation report under Section 404(b). The decision almost universally is tied to potential significant savings in terms of time and money. However, the debate persists over whether the perceived savings are overestimated given the costs companies already incur in connection with IPO due diligence

related to internal controls and that they will incur related to management's opinion on internal control over financial reporting. Further, for any EGC that quickly graduates to large accelerated filer status (*e.g.*, Facebook), the exemption offers no relief that would not otherwise be available based on the newly public company exemption set forth in the instructions to Item 308 of Regulation S-K.

The effect of the newly public company exemption means that we will have to wait until the 2012 EGC class files its second annual report on Form 10-K in early 2014 to determine whether these companies, in fact, have taken advantage of the exemption from the requirements of Section 404(b).

Practice Points

- **Management's Report Under Section 404(a) of Sarbanes-Oxley.** An EGC is not exempt from having to provide management's opinion on internal control over financial reporting. As is the case with virtually all newly public companies, however, an EGC generally would not provide management's opinion until it files its second annual report with the SEC.
- **CEO and CFO Certifications.** The Section 404(b) exemption does not change the requirement for an EGC's CEO and CFO to provide compliance certifications under Sections 302 and 906 of Sarbanes-Oxley in 10-Ks and 10-Qs.

Extended Transition for New GAAP

EGCs are not required to comply with new or revised financial accounting standards until those standards apply to private companies, giving EGCs a longer transition than public companies in situations where a different effective date exists for an accounting standard specified for private companies.

Continued Weak Acceptance. Approximately 76 percent of EGC IPOs that were consummated in 2013 elected not to take advantage of the extended transition period for compliance with new or revised financial reporting standards, as compared to 80 percent of EGC IPOs consummated in 2012. The reasons that EGCs consistently have elected to forego the extended transition period in large numbers are twofold. First, EGCs and their advisors are concerned that taking advantage of the extended transition period will create an unfavorable comparison in the market-place to their competitors. Second, an EGC IPO registration statement still must satisfy the line-item requirements of the relevant Securities Act form, including as it relates to then-current accounting disclosures required by Regulation S-X. Thus, the transition provides only a prospective benefit and is of limited utility, especially when the comparability issues are considered.

Practice Points

- **Opt Out/Opt In.** A determination by an EGC to opt out of or reject the transition period for complying with new or revised financial accounting standards is irrevocable. An EGC should disclose its choice at the time of the initial confidential submission or, if it chooses not to make a confidential submission, at the time it first publicly files its registration statement.[8] An EGC that initially decides to opt in

[8] Title I FAQs, at Question 13.

or take advantage of the extended transition period may determine at any time to opt out (*i.e.*, abandon the extended transition period and comply with the accounting standard effective dates applicable to non-EGCs). This decision, which will be irrevocable, must be disclosed prominently in the EGC's next periodic report or registration statement.[9]

- **Prospectus Disclosure.** If an EGC elects to avail itself of the extended transition period relief, the SEC staff will require the EGC to include disclosure in each of the risk factor and critical accounting policies sections that explains that its financial statements may not be comparable to those companies that comply with public company effective dates.
- **Extended Phase-In for Foreign Private Issuers.** A foreign private issuer that qualifies as an EGC and reconciles its home country GAAP financial statements to U.S. GAAP can take advantage of the extended transition period for complying with new or revised financial accounting standards in its U.S. GAAP reconciliation.[10]

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The JOBS Act has changed significantly the manner in which IPOs are executed. We expect EGCs to continue to take advantage of the confidential submission process and, as circumstances dictate, scaled disclosures and exemptive relief from certain disclosure and other requirements. Other market practices, especially testing-the-waters communications and, potentially, the publication and distribution of research reports, will continue to develop and their impact will become more apparent with the passage of time.

[9] Title I FAQs, at Question 37.

[10] Title I FAQs, at Question 34.