Capital Markets Alert

Skadden

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New Capital Formation Changes and Reduced Disclosure Burdens Enacted As Part of 'FAST Act'

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

Four Times Square
New York, NY 10036
212.735.3000

On December 4, 2015, President Obama signed into law the Fixing America's Surface Transportation Act (FAST Act), which, despite its name, contains several new provisions designed to facilitate capital formation and reduce disclosure burdens imposed on companies under the federal securities laws. The provisions build upon the 2012 Jumpstart Our Business Startups Act (JOBS Act), which created a new category of issuers called "emerging growth companies" (EGCs)[1] and sought to encourage EGCs to go public in the United States.[2] The FAST Act provisions, which were first introduced in a package of bills often called "JOBS Act 2.0," are the culmination of a continuing congressional effort to increase initial public offerings (IPOs) by EGCs, reduce the burdens on smaller companies seeking to conduct registered offerings and provide trading liquidity for securities of private companies.

While some of the new provisions require rulemaking by the U.S. Securities and Exchange Commission (SEC) before they are effective, other provisions of the FAST Act amend the Securities Act itself and therefore are effective, with an immediate effect on current offerings.

Changes to EGC Offering Process

The FAST Act expands some of the "IPO On-Ramp" accommodations extended to EGCs under the JOBS Act by further easing the Securities Act registration and offering process for such companies.

- **New Deadline for Public Filing of Confidential Submissions.** Currently, an EGC may confidentially submit a draft registration statement for its IPO for non-public review, provided that the confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the EGC commences a roadshow. The FAST Act amends Section 6(e) of the Securities Act to reduce the requirement for public filing to no later than 15 days before the roadshow. The change will allow EGCs greater flexibility when assessing market windows and determining the opportune time to launch an IPO. Since confidential submissions have been widely used since the adoption of the JOBS Act, we expect issuers to immediately take advantage of this increased flexibility.

[1] An EGC is an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. An issuer that is an EGC would continue to be considered an EGC until the earliest of:
- the last day of the fiscal year during which it had total annual gross revenues of at least $1 billion;
- the last day of the fiscal year following the fifth anniversary of the IPO of its equity;
- the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or
- the date on which it is considered to be a "large accelerated filer" under the Exchange Act.

[2] A summary of the JOBS Act is available here.

- **"Locking in" EGC Status at the Time of Confidential Submission.** While the JOBS Act created the EGC category and provided for the confidential submission process, it was silent as to when EGC status should be determined. In response, in 2012, the SEC staff published interpretive guidance that an issuer must qualify as an EGC at the time of the submission of the confidential draft registration statement.[3] If the issuer no longer qualifies as an EGC during the course of the confidential review process (for example, its total annual revenues for the fiscal year exceeded $1 billion), it would need to file publicly the registration statement and would not be able to avail itself of the EGC benefits.

The FAST Act overrules this guidance by amending Securities Act Section 6(e) to provide that an issuer that qualified as an EGC at the time of the submission of the draft registration statement (or, alternatively, a publicly filed registration statement) can retain its EGC status through the earlier of (1) the date of the consummation of the IPO covered by the registration statement or (2) the end of the one-year period beginning on the date the issuer lost its EGC status. Accordingly, while the issuer may quickly lose the ongoing benefits of being an EGC (*i.e.*, reduced compensation disclosure and no auditor attestation on internal controls), the issuer nevertheless would be able to take advantage of the benefits of being an EGC in conducting its IPO (*i.e.*, reduced financial statements requirements), so long as it completes its IPO prior to the end of the one year period. Issuers that lose EGC status upon consummation of the IPO, however, will have to wait longer for the initiation of research coverage as they would be unable to benefit from the increased flexibility extended by the JOBS Act for research reports with respect to securities of EGCs.[4]

- **Omission of Financial Statements for Certain Historical Periods.** The SEC must revise Form S-1 and Form F-1 by January 3, 2016 (30 days after enactment) to allow an EGC to omit from its draft registration statement (or a publicly filed registration statement) financial statements for periods that would otherwise be required under Regulation S-X if:
  - the EGC reasonably believes that such periods would not be required in the Form S-1 or Form F-1 at the time of the contemplated offering; and
  - prior to the distribution of a preliminary prospectus, the EGC amends the registration statement to include all financial statements required by Regulation S-X at the date of the amendment.

The FAST Act expressly states that beginning 30 days after enactment, EGCs will be able to omit such financial statements from Form S-1 or F-1 in reliance on the statute (and, apparently, irrespective of whether the SEC completes the mandated revisions to Form S-1 or F-1). This change applies to an issuer's financial statements as well as pro forma and acquired company financial statements. The change will help issuers avoid the expense and time needed to prepare financial statements that will not be required by the time the offering commences. It may prove particularly helpful for older and non-material periods and eliminates the need for an issuer to submit a waiver request to the SEC staff to omit financial statements for such periods.

New Securities Act Exemption for Private Resales

The FAST Act creates a new statutory exemption from Securities Act registration for private resales to accredited investors and, in effect, codifies the longstanding informal "Section 4(a)(1 ½)" exemption for private resales.[5] Under the new Securities Act Section 4(a)(7) exemption, a resale would be exempt from registration as long as:

- the purchaser is an accredited investor, as defined in Rule 501 of Regulation D;
- the seller (or any person acting on behalf of the seller) does not use general solicitation to offer or sell the securities;
- if the securities are those of an issuer that is not subject to the Exchange Act reporting obligations, then the seller and the prospective purchaser obtain certain information from the issuer;[6]

[3] See Answer to Question 3 of the Generally Applicable Questions on Title I of the JOBS Act, "Jumpstart Our Business Startups Act Frequently Asked Questions," available at: http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

The guidance is based on Securities Act Rule 401(a), which states that the "form and contents of a registration statement and prospectus shall conform to the applicable rules and forms in effect on the initial filing date of such registration statement and prospectus" [emphasis added], and the SEC staff's conclusion that the submission date of the draft registration statement is not the "initial filing date."

[4] For example, the JOBS Act amended the Exchange Act to prohibit the SEC and any registered national securities association from adopting or maintaining any rule or regulation prohibiting any broker, dealer or member of a national securities association from publishing or distributing any research report or making a public appearance with respect to the securities of an EGC during post-IPO quiet and lock-up periods.

[5] This codification of Section 4(a)(1 ½) follows the SEC's recognition of the informal exemption over 20 years ago when it adopted Securities Act Rule 144A, which exempts from Securities Act registration private resales of securities to qualified institutional buyers (QIBs).

[6] The mandated issuer information is similar to that required for resales conducted under Rule 144A and includes, among other things: a business description; names of officers and directors of the issuer; the most recent balance sheet and profit and loss statements; and, if the seller is a control person of the issuer, a description of the affiliation between the seller and the issuer.

- the seller (or a person compensated for the sale) is not subject to an event that would trigger the "bad actor" disqualification provision of Securities Act Rule 506(d);[7]
- the securities must have been outstanding for at least 90 days prior to the date of the resale; and
- the securities are not part of an unsold allotment to an underwriter (such as an investment bank acting as an underwriter in an IPO).

Consistent with its purpose of facilitating resales, the new exemption is not available for sales by the issuer or its subsidiaries (and therefore cannot be used for primary offerings by issuers), but is available for affiliates of the issuer. Further, the securities must be those of an issuer "engaged in business" and cannot be those of certain types of issuers, such as shell companies or blank check companies.

Securities sold pursuant to the new Section 4(a)(7) exemption would be "restricted securities," as defined by Securities Act Rule 144. Notably, unlike Rule 144, the new exemption does not impose any holding period requirement for the securities to be resold, other than the requirement that the securities must have been outstanding for at least 90 days. Finally, the FAST Act amends Securities Act Section 18 to pre-empt state blue sky requirements for resales conducted under the new exemption. The availability of this new exemption for resales, combined with the increase in the threshold for triggering the registration requirement of Exchange Act Section 12(g),[8] could lead to growth in private trading markets, provided that private companies become comfortable with providing the issuer information required under the exemption.

Ability of Smaller Reporting Companies to Incorporate by Reference Future Filings

The FAST Act requires the SEC to amend Form S-1 to permit a smaller reporting company to incorporate by reference any Exchange Act filings that it makes after the registration statement's effective date.[9]The SEC must make this revision to Form S-1 no later than January 18, 2016 (45 days after the enactment of the FAST Act).

Currently, Form S-1 only permits the registrant to incorporate by reference previously filed Exchange Act reports, provided that certain conditions are satisfied.[10] The ability to incorporate future Exchange Act reports, or forward incorporation by reference, is generally available only to companies eligible to use Form S-3 or F-3, the short-form Securities Act registration statements. Once the Form S-1 is amended as required by the FAST Act, smaller reporting companies will have the benefit of forward incorporation by reference and therefore can update their Form S-1 registration statements as required by Securities Act Section 10(a)(3) without having to file post-effective amendments, which could be subject to SEC review. This change will not affect smaller reporting companies' ability to conduct delayed shelf offerings which, as required by Securities Act Rule 415(a)(1)(x), is still dependent on the issuer's eligibility to use Form S-3 or F-3. Smaller reporting companies, however, can take advantage of the change for other types of Rule 415 offerings, such as resale transactions or continuous offerings that commence promptly after effectiveness and continue for a period in excess of 30 days

[7] Under Rule 506(d), an offering is disqualified from relying on Rule 506 of Regulation D if the issuer or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order, or other disqualifying event that occurred on or after September 23, 2013, the effective date of the rule amendments. Events that could trigger disqualifications include: (1) criminal convictions in connection with the purchase or sale of securities; (2) SEC cease-and-desist orders for violations of scienter-based anti-fraud provisions of the federal securities laws and Section 5 of the Securities Act; and (3) certain final orders of state regulators, federal banking agencies and other federal agencies (such as the Commodity Futures Trading Commission).

While Rule 506(d) expressly provides for a waiver process to avoid disqualification from relying on the Rule 506 exemption, the FAST Act does not mandate a similar waiver process for sellers seeking to rely on the new Section 4(a)(7) exemption for their resales.

[8] The JOBS Act amended Exchange Act Section 12(g) to raise the number of record holders of a class of equity securities from 500 to 2,000, so long as not more than 499 shareholders are non-accredited investors. It also excluded shareholders who received their shares pursuant to exempt transactions under an employee compensation plan from counting toward the new shareholder threshold.

[9] A "smaller reporting company," as defined by Securities Act Rule 405 and Exchange Act Rule 12b-2, is an issuer that:
- had a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter;
- in the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than $75 million as of a date within 30 days of the date of the filing of the registration statement; or
- in the case of an issuer whose public float was zero, had annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available.

The issuer must not be an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent company that is not a smaller reporting company.

[10] General Instruction VII of Form S-1. These conditions include: the registrant must be subject to the Exchange Act reporting obligations, the registrant must have filed all Exchange Act reports for the preceding 12 months and the registrant must have filed an annual report for the most recently completed fiscal year.

It remains to be seen as to whether, in amending Form S-1, the SEC will impose similar conditions on the ability to incorporate by reference future Exchange Act reports. For example, absent any SEC-imposed conditions, it appears possible for a smaller reporting company to be able to incorporate by reference future Exchange Act reports, as allowed by the FAST Act, but be unable to incorporate by reference previous Exchange Act reports due to the current requirements of Form S-1.

after effectiveness.[11] Finally, under the FAST Act, larger companies, such as large accelerated filers[12] or well-known seasoned issuers (WKSIs),[13] will still be unable to forward incorporate by reference their Exchange Act reports in Form S-1.

Regulation S-K Modernization and Form 10-K Summary

The FAST Act mandates the SEC to take several actions to address concerns about the disclosure burdens on public companies, particularly smaller issuers.

- **New Regulation S-K Study.** The SEC must conduct a study of Regulation S-K to (1) determine how to simplify the requirements and reduce the burdens on issuers while providing material information; (2) determine how to emphasize the provision of company-specific information, avoidance of boilerplate, and preservation of completeness and comparability of information across registrants; and (3) evaluate methods for presenting and delivering disclosure that would discourage repetition and immaterial information.

The SEC must deliver the study, with specific recommendations, to Congress 360 days after enactment of the FAST Act (November 28, 2016). Once the report is delivered to Congress, the SEC will have 360 days to propose rules to implement the study's recommendations.

- **Changes to Regulation S-K.** Within 180 days after enactment, by June 1, 2016, and if no further consideration is needed under the study described above, the SEC must revise Regulation S-K to (1) scale the disclosure requirements to reduce burdens on EGCs, accelerated filers, smaller reporting companies and other smaller companies while still providing material information (larger companies, such as large accelerated filers, are notably left out from this provision); and (2) eliminate "duplicative, overlapping, outdated, or unnecessary" provisions of Regulation S-K for all issuers.
- **Form 10-K Summary Page.** Within 180 days after enactment, by June 1, 2016, the SEC must issue rules to permit companies to include a summary page in a Form 10-K, provided that the summary includes cross-references to the fuller discussions in the Form 10-K.

Conclusions

EGCs and security holders of private companies should be able to enjoy meaningful benefits from the new FAST Act provisions. EGCs contemplating public offerings can have greater certainty as to their EGC status during the registration process, commence their roadshows more quickly once they publicly filed their registration statements, and avoid the need to prepare financial statements that may be unnecessary by the time of the offering's launch. With the exception of the accommodation for financial statements, which is expressly available 30 days after enactment, all of the EGC provisions are immediately effective.

For security holders of private companies, Congress has effectively codified the informal "Section 4(a)(1½)" exemption for private resales through the creation of the new Section 4(a)(7) exemption. By doing so, the new exemption, which became available upon enactment of the FAST Act on December 4, 2015, could provide the legal certainty needed to encourage increased resales by security holders of private companies (such as employees) and provide trading liquidity for such securities. At the same time, however, the information requirement of the new exemption could exert greater pressure on private companies to make information about themselves available publicly.

The remaining FAST Act provisions, such as the ability of smaller reporting companies to incorporate by reference future Exchange Act reports in a Form S-1, require future SEC rulemakings or actions before their benefits are available to eligible companies.

[11] Securities Act Rules 415(a)(1)(i) and 415(a)(1)(ix).

[12] A "large accelerated filer," as defined by Exchange Act Rule 12b-2, is an issuer that meets all of the following conditions as of the end of its fiscal year:
- the issuer's public float of its common equity was $700 million or more as of the last business day of its most recently completed second fiscal quarter;
- the issuer has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for at least 12 calendar months;
- the issuer previously has filed at least one annual report under Section 13(a) or 15(d) of the Exchange Act; and
- the issuer is not eligible to rely on the smaller reporting company requirements for its annual and quarterly reports.

[13] Under Securities Act Rule 405, a WKSI is an issuer that meets the registrant requirements of Form S-3 or Form F-3 and either: (1) as of a date within 60 days of determination date, has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of $700 million or more; or (2) as of a date within 60 days of the determination date, has issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act. In addition, the issuer may not be an "ineligible issuer," as defined in Rule 405.

Capital Markets Alert
Contacts

New York

Ryan J. Dzierniejko
Partner
212.735.3712
ryan.dzierniejko@skadden.com

Gregory A. Fernicola
Partner
212.735.2918
gregory.fernicola@skadden.com

David J. Goldschmidt
Partner
212.735.3574
david.goldschmidt@skadden.com

Laura A. Kaufmann Belkhayat
Partner
212.735.2439
laura.kaufmann@skadden.com

Andrea L. Nicolas
Partner
212.735.3416
andrea.nicolas@skadden.com

Michael J. Schwartz
Partner
212.735.3694
michael.schwartz@skadden.com

Yossi Vebman
Partner
212.735.3719
yossi.vebman@skadden.com

Dwight S. Yoo
Partner
212.735.2573
dwight.yoo@skadden.com

Michael J. Zeidel
Partner
212.735.3259
michael.zeidel@skadden.com

Los Angeles

Michelle Gasaway
Partner
213.687.5122
michelle.gasaway@skadden.com

Palo Alto

Thomas J. Ivey
Partner
650.470.4522
thomas.ivey@skadden.com

Gregg A. Noel
Partner
650.470.4540
gregg.noel@skadden.com

Washington, D.C.

Brian V. Breheny
Partner
202.371.7180
brian.breheny@skadden.com

Andrew J. Brady
Of Counsel
202.371.7513
andrew.brady@skadden.com

Frankfurt

Stephan Hutter
Partner
49.69.74220.170
stephan.hutter@skadden.com

Hong Kong

Z. Julie Gao
Partner
852.3740.4863
julie.gao@skadden.com

Jonathan B. Stone
Partner
852.3740.4703
jonathan.stone@skadden.com

London

James A. McDonald
Partner
44.20.7519.7183
james.mcdonald@skadden.com

Danny Tricot
Partner
44.20.7519.7071
danny.tricot@skadden.com

Pranav L. Trivedi
Partner
44.20.7519.7026
pranav.trivedi@skadden.com

Singapore

Rajeev P. Duggal
Partner
65.6434.2980
rajeev.duggal@skadden.com

Sydney

Adrian J. S. Deitz
Partner
61.4294.44311
adrian.deitz@skadden.com

Tokyo

Kenji Taneda
Partner
81.3.3568.2640
kenji.taneda@skadden.com

Toronto

Riccardo A. Leofanti
Partner
416.777.4703
riccardo.leofanti@skadden.com

Counsel **Ted Yu** assisted in the preparation of this alert.