Capital Markets Alert

Skadden

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Public Market Advocacy Groups Release Guidance

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.

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On April 27, 2018, the Securities Industry and Financial Markets Association (SIFMA), the U.S. Chamber of Commerce and Nasdaq, along with certain technology and biotechnology groups, released a policy paper titled "Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public" (SIFMA Paper).

The report, motivated by a concern that the decline in the number of U.S. public companies has inhibited opportunities for American businesses, proposes a number of regulatory changes designed to further streamline the initial public offering (IPO) process and ease the costs and burdens of remaining public. Certain of the recommendations mirror or otherwise can be tied to proposals contained in various recent congressional initiatives (*e.g.*, the Financial Choice Act of 2017) or pending recommendations from a number of Securities and Exchange Commission (SEC or Commission) advisory committees or forums. While the list of recommendations might best be described as an ambitious "wish list," given the current regulatory environment and SEC focus on capital formation, we expect that certain of these items may generate traction on Capitol Hill and/or at the SEC.

The following is a summary of the key capital markets reforms contained in the paper.

Recommendations That Extend Accommodations Provided by the Jumpstart Our Business Startups Act (JOBS Act)
Extend emerging growth company (EGC) eligibility from five years after an IPO to 10 years
Permit all issuers, not just EGCs, to use "testing-the-waters" communications
Extend the exemption from the auditor attestation provision of the Sarbanes-Oxley Act (SOX) from five years to 10 years for certain EGCs
Remove the phase-out provision from the definition of EGC to allow large accelerated filers to remain as EGCs
Recommendations to Encourage Research of EGCs and Other Small Companies
Remove the requirement that companies be Form S-3 or F-3 eligible to permit broker-dealers to use the Rule 139 research safe harbor
Allow investment banking and research analysts to jointly attend "pitch meetings"
Commission a report by the SEC on pre-IPO research

Recommendations Regarding Corporate Governance, Disclosure and Other Regulatory Requirements
Institute SEC oversight of proxy advisory firms
Increase resubmission threshold for shareholder proposals
Allow EGCs to replace quarterly Exchange Act reports with earnings releases
Expand issuer shelf registration statement eligibility
Eliminate eXtensible Business Reporting Language (XBRL) requirement for EGCs, smaller reporting companies (SRCs) and non-accelerated filers
Reject disclosure initiatives that do not provide material information to investors
Allow purchases of EGC shares to be qualifying investments for purposes of registered investment adviser exemptions
Encourage enforcement activity against manipulative short-sellers
Allow underwriters to make offers of well-known seasoned issuer (WKSI) securities before they file registration statements
Increase the threshold for mutual funds to take positions in companies before triggering diversified fund limits from 10 percent to 15 percent
Allow disclosure of selling stockholders on a group basis
Recommendations Related to Financial Reporting
Increase public float cap for SRCs and non-accelerated filers to $250 million
Modernize Public Company Accounting Oversight Board (PCAOB) inspection process
Recommendations Related to Equity Market Structure
Allow nonstandard tick sizes
Allow EGCs and small issuers with distressed liquidity to opt out of unlisted trading privileges

Recommendations That Extend Accommodations Provided by the JOBS Act

Extend EGC Eligibility From Five Years After an IPO to 10 Years

The JOBS Act introduced reduced reporting requirements for issuers that meet the definition of an EGC. Under the current definition, a company continues to be an EGC for five years following the completion of its IPO unless a disqualifying event occurs. The SIFMA Paper recommends extending EGC status to 10 years after an IPO, which it argues will be a further incentive for businesses to go public.

Permit All Issuers, Not Just EGCs, to Use 'Testing-the-Waters' Communications

The JOBS Act significantly eased long-standing 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 and institutional accredited investors ("testing-the-waters" communications) before or after the filing of a registration statement to gauge investors' nonbinding interest in the offering. Testing the waters has since become a standard part of the IPO playbook for EGCs. The SIFMA Paper recommends expanding Section 5(d) of the Securities Act to permit all issuers, not just EGCs, to engage in testing-the-waters communications.

Similarly, on April 26, 2018, SEC Division of Corporation Finance Director Bill Hinman told the House Financial Services Committee that the staff is considering recommending that the SEC propose amendments to expand "testing-the-waters" benefits to all companies.

Extend the Exemption From Auditor Attestation Provision of SOX From Five Years to 10 Years for Certain EGCs

Under Section 404 of SOX and related SEC rules, each annual report of a public company (other than the initial annual report for a newly reporting public company) must contain a report on internal control over financial reporting that, among other things, includes management's opinion on the effectiveness of the company's internal control over financial reporting. The JOBS Act exempted EGCs from the separate requirement that an issuers' independent auditor include an attestation report on the effectiveness of the company's internal control over financial

reporting for the first five years after going public. The Section 404 auditor attestation requirement has long been considered a disincentive to being a public company. The SIFMA Paper recommends extending the auditor attestation exemption for EGCs from five years to 10 years for EGCs that have less than $50 million in revenue and less than $700 million in public float (*i.e.*, the aggregate market value of the voting and nonvoting common equity held by nonaffiliates).

Remove the Phase-Out Provision From the Definition of EGC to Allow Large Accelerated Filers to Remain as EGCs

Currently, during the first five fiscal years after it completes an IPO, an issuer will maintain its EGC status until the earliest of (1) the last day of the fiscal year in which its total annual gross revenues are $1.07 billion or more, (2) any date on which the issuer has, during the prior three-year period, issued more than $1 billion in nonconvertible debt or (3) the date on which it becomes a "large accelerated filer," which is defined in Exchange Act Rule 12b-2 as an issuer that has a public float of $700 million or more (on the last day of its second fiscal quarter). The SIFMA Paper recommends eliminating the large accelerated filer disqualification. This recommendation would effectively allow EGCs that have not otherwise experienced a disqualification event to maintain their status for up to five years even if they cross a market capitalization threshold that triggers requirements to become large accelerated filers.

Recommendations to Encourage Research of EGCs and Other Small Companies

Remove the Requirement That Companies Be Form S-3 or F-3 Eligible to Permit Broker-Dealers to Use the Rule 139 Research Safe Harbor

Securities Act Rules 137, 138 and 139 set forth nonexclusive safe harbors that allow a broker or dealer to publish research contemporaneously with a registered offering without running afoul of the statutory definition of "underwriter" (Rule 137) or Section 5 (Rules 138 and 139). Rule 139 covers (1) focused research reports distributed with reasonable regularity in the normal course of business that focus on the issuer and/or its securities and (2) industry research reports distributed with reasonable regularity in the normal course of business with respect to a substantial number of companies where the information about the issuer is given no greater prominence than the information about other companies. Issuer-focused reports are permitted only for "seasoned issuers" and "qualifying foreign private issuers," *i.e.*, generally those eligible to use Form S-3 or F-3, respectively. The SIFMA Paper recommends amending Rule 139 to cover issuer-focused research by any issuer, not just those that qualify for Form S-3/F-3, thereby providing a path for greater research coverage in an issuer's first year of being public.

Allow Investment Banking and Research Analysts to Jointly Attend 'Pitch Meetings'

Under the JOBS Act, investment banking research and analysts may jointly attend pitch meetings, but analysts are prohibited from engaging in efforts to solicit investment banking business. To reconcile these two items, the SEC has provided guidance with examples of what analysts may discuss, which, in practice, is limited.[1] SIFMA contends that as a consequence, bankers and analysts do not jointly attend pitch meetings, despite the intent of the JOBS Act. The SIFMA Paper recommends that the SEC consider the removal of barriers prohibiting investment banks and analysts from jointly attending meetings (including pitches) for EGCs and expressly expand the permitted content that can be discussed at such meetings so long as no direct or indirect promises of favorable research are given.[2]

Commission a Report by the SEC on Pre-IPO Research

By excluding research reports on an EGC equity IPO from the definition of "offer" in Section 2(a)(3), the JOBS Act sought to encourage (and permit) investment banks to publish pre-IPO research on such offerings. Despite this, SIFMA observes that very few investment banks have published pre-IPO research. The SIFMA Paper recommends that the SEC examine this issue and release a report on what, if any, regulatory or liability burdens continue to exist that may effectively prohibit investment banks from publishing pre-IPO research.

Recommendations Regarding Corporate Governance, Disclosure and Other Regulatory Requirements

Institute SEC Oversight of Proxy Advisory Firms

Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, have become increasingly important in recent years in setting standards for corporate governance. The

[1] Jumpstart Our Business Startups Act, Frequently Asked Questions About Research Analysts and Underwriters, Division of Trading and Markets (Aug. 22, 2012).

[2] Any SEC action would not amend or modify the so-called Global Settlement, where the SEC, self-regulatory organizations and other regulators settled enforcement actions against 12 broker-dealers to address conflicts of interest and require firewalls between the firms' research and investment banking functions. Rather, any amendment or modification to the Global Settlement would have to be approved by the court overseeing that settlement. SIFMA is encouraging a review of the Global Settlement to permit settlement banks to be able to take advantage of the proposal.

SIFMA Paper notes that ISS and Glass Lewis together control over 97 percent of proxy advisory market share. Two SEC no-action letters issued in 2004, Egan-Jones Proxy Services and Institutional Shareholder Services, Inc., are viewed as essentially allowing advisers to determine, in accordance with the SEC's statements in the proxy voting release and the terms of the letters, that voting in reliance on an independent proxy advisory firm's voting recommendations insulates the voting decision from any conflicts of interest the adviser may have. These letters are also commonly seen as blocking SEC review of reliance on proxy advisory firms (and otherwise discharge the adviser's fiduciary duties and meet the requirements of the proxy voting rule that votes be cast in the client's best interest). The SIFMA Paper recommends that the SEC withdraw the Egan-Jones and ISS no-action letters and voices support for legislation that would require proxy advisory firms to disclose and manage their conflicts of interest, provide issuers with a reasonable amount of time to respond to errors or flaws in voting recommendations, and demonstrate they have the expertise and capabilities to provide accurate and objective recommendations.

Increase Resubmission Threshold for Shareholder Proposals

Currently, shareholders conditionally may submit proposals to be voted on at a company's annual meeting. These proposals will be included on a company's proxy, unless a company is able to use one of the 13 exemptions that exist under Rule 14a-8. One of these exemptions applies to "resubmissions," where a company may exclude a proposal from its proxy statement if it failed to receive the support of: (1) 3 percent of shareholders the last time it was voted on (if voted on once in the past five years); (2) 6 percent of shareholders the last time it was voted on (if voted on twice in the past five years); or (3) 10 percent of shareholders the last time it was voted on (if voted on three or more times in the past five years). The SIFMA Paper recommends adopting a 6 percent/15 percent/30 percent threshold. It also recommends withdrawal of Staff Legal Bulletin 14H (CF), which provided guidance on the exemption under Rule 14a-8(i)(9), which allows companies to exclude proposals that "directly conflict" with a management proposal. The Staff Legal Bulletin introduced a more narrow view of Rule 14a-8(i)(9), which focused on interpretation based on a "reasonable shareholder" standard.

Allow EGCs to Replace Quarterly Exchange Act Reports With Earnings Releases

Public companies that report under the Exchange Act are subject to requirements to file current, quarterly and annual reports with the SEC. The SIFMA Paper recommends granting EGCs the option of issuing a press release that includes earnings results every quarter in lieu of a full Form 10-Q. Presumably the press release would not need (but could include voluntarily) a narrative management's discussion and analysis of financial position and results of operations section. SIFMA believes this option would provide investors with the material information necessary to make informed decisions but would reduce certain unnecessary burdens associated with the current quarterly reporting system.

Expand Issuer Shelf Registration Statement Eligibility

Forms S-3 and F-3 are the "short form" registration statements used by eligible domestic companies and foreign companies, respectively, to register securities offerings under the Securities Act. Most prominently, the forms allow these companies to (1) incorporate by reference their historical and future reports filed or to be filed under the Exchange Act to satisfy the form's disclosure requirements, and (2) conditionally conduct opportunistic offerings (shelf takedowns) by filing a prospectus supplement(s) not subject to SEC staff review/delay. Each of the forms has certain registrant and transactional requirements, which effectively limit their use to companies that have a 12-month history of timely Exchange Act reporting and, in the case of shelf takedowns for cash, companies that have a public float of $75 million or more. The SIFMA Paper recommends allowing issuers to use Forms S-3 and F-3 without regard to their public float.

Eliminate XBRL Requirement for EGCs, SRCs and Non-Accelerated Filers

SEC rules currently require operating companies to provide information from the financial statements accompanying registration statements and periodic and certain current reports in XBRL format. The XBRL requirements apply to operating companies that prepare their financial statements in accordance with U.S. generally accepted accounting principles or International Financial Reporting Standards as issued by the International Accounting Standards Board. The SIFMA Paper recommends exempting

EGCs, SRCs and non-accelerated filers from the requirement to use XBRL for financial statements and other periodic reporting, although such issuers may elect to continue to use it.

Reject Disclosure Initiatives That Do Not Provide Material Information to Investors

The SIFMA Paper highlights what it calls the "troubling trend" of the SEC's disclosure regime being used to "advance agendas that are uncorrelated with the historical purpose of the securities laws." It highlights the Dodd-Frank Act's conflict minerals and pay ratio rules as examples of this trend. The SIFMA paper argues that these legislative initiatives constitute attempts to erode the materiality standard for corporate disclosure and that they should be discouraged in favor of a return to the fundamental materiality standard.

Allow Purchases of EGC Shares to Be Qualifying Investments for Purposes of Registered Investment Adviser Exemptions

The SEC regulates investment advisers pursuant to the Investment Advisers Act of 1940 (Advisers Act) and the rules promulgated thereunder. One of the central elements of the regulatory regime is the requirement that a person or firm meeting the definition of "investment adviser" under the Advisers Act register with the SEC unless exempt or prohibited from registration. The Dodd-Frank Act sought to exempt venture capital funds from the costs and challenges associated with becoming an registered investment adviser. However, SIFMA argues that the definition of "venture capital fund" promulgated by the SEC in Advisers Act Rule 203(1)-1 was too narrowly drawn and did not meet the Dodd-Frank statutory obligations of a full venture capital exemption. The SIFMA Paper argues that shares of EGCs, including the purchase of EGC shares on the secondary market, should be considered qualifying investments, which will create a more accurate venture capital exemption definition and would expand the pool of potential investors for EGCs.

Encourage Enforcement Activity Against Manipulative Short-Sellers

The SIFMA Paper notes that while there are extensive public disclosure obligations for investors who invest in companies expecting growth, no such requirements exist for those investors who take a short position in the company's stock or use other investment instruments to enable investors to profit from the loss of a company's equity value. Out of a concern that market manipulators can engage in abusive forms of short-selling that unduly harm investors or the reputation of a company, the SIFMA Paper recommends that the SEC remain vigilant in taking action against manipulators that unlawfully engage in activities that harm the overall markets and in ensuring there is sufficient public information about potential market manipulation.

Allow Underwriters to Make Offers of WKSI Securities Before They File Registration Statements

Securities Act Rule 163 permits a WKSI to offer securities before filing a related registration statement. However, as currently drafted, Rule 163 applies only to communications made "by or on behalf of the issuer itself." In 2009, the SEC proposed an amendment to Rule 163 that would permit a WKSI to authorize an underwriter or dealer to act as its agent or representative for purposes of making prefiling communications. The SIFMA Paper recommends adopting this change so that underwriters and dealers can act as agents on behalf of WKSIs in making efforts in advance of the filing of the registration statement.

Increase the Threshold for Mutual Funds to Take Positions in Companies Before Triggering Diversified Fund Limits From 10 Percent to 15 Percent

Under current SEC rules, a mutual fund cannot call itself "diversified" unless at least 75 percent of its assets are in securities, with no more than 5 percent in any one company and with no holdings above 10 percent of a company's voting securities. The SIFMA Paper recommends increasing this threshold to 15 percent, as the size of mutual funds have increased in recent years. SIFMA argues that the diversified fund limit rules have constrained their ability to take meaningful positions in small-cap companies.

Allow Disclosure of Selling Stockholders on a Group Basis

Item 507 of Regulation S-K requires certain disclosures concerning each selling shareholder for whose account the securities being registered are to be offered. The SEC has permitted this disclosure to be made on a group basis as opposed to an individual basis where the aggregate holding of the group is less than 1 percent of the class prior to the offering. Where this is the case except for a few major shareholders, the disclosure for the members of the group other than the major shareholders also may be made on a group basis. The SIFMA Paper recommends allowing disclosure of selling stockholders to be done on a group basis even if each selling stockholder in the group (1) is not a director or named executive officer of the registrant and (2) holds less than 1 percent of outstanding shares.

Recommendations Related to Financial Reporting

Increase Public Float Cap for SRCs and Non-Accelerated Filers to $250 Million

Currently, companies may qualify as both an SRC and a non-accelerated filer if their public float falls below $75 million. In 2016, the SEC issued a proposed rule that would have increased the public float cap for SRCs, but not non-accelerated filers, to $250 million. The SIFMA Paper argues that in considering its proposal to broaden eligibility for SRCs, the SEC should consider aligning the SRC definition with that of a non-accelerated filer.

The 2016 SRC proposal also proposed adopting an alternative "revenue only" test for companies to qualify as SRCs if they had less than $100 million in revenue, regardless of their public float. The SIFMA Paper argues that a revenue-only test of $100 million (which the SEC proposed as part of the SRC proposal) should be considered as an alternative for companies to the existing public float standard.

Modernize the PCAOB Inspection Process

A major focus of SOX was to create a system of management assessments and auditor attestations regarding the effectiveness of internal control over financial reporting (ICFR) under Section 404. In order to provide companies with principles-based guidance to facilitate the conduct of management's assessment of the effectiveness of ICFR, in 2007 the SEC issued "Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934" (Management Guidance). The goal of the Management Guidance was to allow companies to prioritize and focus on "what matters most" in assessing ICFR, such as material issues that pose the greatest risk of material misstatements. The SEC's guidance allows management to exercise significant judgment in designing, conducting and documenting an assessment of ICFR tailored to a company's individual facts and circumstances. The SIFMA Paper recommends that the existing Management Guidance be reviewed and revised to ensure it is working as intended. It also recommends that the PCAOB consider forming an ICFR task force to address issues that arise for companies as a result of the PCAOB inspection process and its consequences for audit firms and auditors. The SIFMA Paper further recommends pre- and post-implementation reviews by the PCAOB to improve audit standard setting, prevent harmful impacts and address unintended consequences that actually occur in the process of implementing PCAOB auditing standards.

Recommendations Related to Equity Market Structure

Allow Nonstandard Tick Sizes

In 2000, the SEC issued its "decimalization" order, which transitioned the trading of most U.S. stocks to penny increments as opposed to fractions. The SIFMA Paper argues that decimalization is good for highly traded stocks, but that the narrow spreads generated by penny increments can serve as a disincentive for market makers to trade the shares of EGCs or other small issuers. The SIFMA Paper recommends that smaller issuers be permitted to select their own tick size.

Allow EGCs and Small Issuers With Distressed Liquidity to Opt Out of Unlisted Trading Privileges

Securities exchanges, which are components of the National Market System, provide a venue for securities buyers to establish prices for and execute securities transactions. While securities are listed on a primary exchange, they can be traded on any national securities exchange (or other trading venues such as alternative trading systems) through a system of unlisted trading privileges (UTP). For example, UTP allows a company that lists on the New York Stock Exchange to be traded on other trading venues, such as the Nasdaq composite. In 2005, the SEC adopted Regulation NMS, which updated earlier rulemakings that were intended to strengthen and modernize the National Market System. Regulation NMS included new substantive rules to modernize and strengthen the regulatory structure of the U.S. financial markets. The SIFMA Paper recommends that EGCs and other small issuers with distressed liquidity be able to suspend their unlisted trading privileges in order to concentrate exchange trading and liquidity on a single exchange.

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SEC Chairman Jay Clayton Addresses Mandatory Arbitration Provisions

In an April 24, 2018, letter to House Rep. Carolyn Maloney, D-N.Y. (Clayton Letter), SEC Chairman Jay Clayton addressed the use of mandatory arbitration provisions in IPOs. In the letter, Clayton noted that "should a U.S. company pursue a registered IPO with a mandatory arbitration clause in its governing documents, the decision about whether to declare the filing effective should be made by the full Commission, not the Division by delegated authority," and any such review "should be conducted in a measured and deliberative manner."

Clayton added that he had not formed a definitive view on whether or not mandatory arbitration for shareholder disputes would be appropriate in the context of an IPO for a U.S. company, and that any decision on this issue would be dependent on facts and circumstances. He also stated that the issue is not a priority for him.

Historically, the SEC has not permitted forced arbitration clauses in IPOs. The issue last arose in the context of an IPO of a U.S. company in 2012, when the Division of Corporation Finance took the position that it would not use its delegated authority to accelerate the effective date of the company's registration statement because it was unable to conclude that such mandatory arbitration provisions were consistent with "the public interest and protection of investors" as required by Securities Act Section 8(a). More specifically, at that time, the staff advised a company that it did not anticipate exercising its delegated authority to accelerate the effective date of the registration statement if such a provision was included in the company's governing documents. It also said the Commission would need to make any decision on a request for acceleration.

The staff reiterated this position in the Clayton Letter, writing that if a domestic company filed a registration statement for an IPO with a mandatory arbitration provision today, the staff would not use its delegated authority to accelerate the effective date of the registration statement. Instead, it would refer the request for acceleration to the full Commission.

The staff also indicated that enforcement of mandatory arbitration provisions is generally a state law matter and the Commission does not have rules permitting or prohibiting companies from using arbitration provisions.

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