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A tipping point in US capital markets: the impact of the JOBS Act on foreign issuers

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For most of the 20th century and into the 21st century, the US equities market has been the deepest, broadest and largest equities market in the world. Historically, growing companies, whether domestic or foreign, have sought to raise capital in the US.

However, for both domestic and foreign issuers, the costs associated with conducting an initial public offering (IPO) in the US (along with the additional disclosure, corporate governance and other requirements applicable to US public companies, which must report to the US financial securities regulator, the Securities and Exchange Commission (SEC)), can be daunting. Public companies are also subject to greater scrutiny in relation to their operations, and companies and their officers and directors face heightened liability risks. In addition, following changes to the market structure, the enactment of the Sarbanes-Oxley Act and the general perception that the regulatory requirements to be met to finance companies in the US had become overly burdensome, many companies sought alternatives. Therefore, instead of pursuing an IPO in the US, many domestic and foreign issuers chose to:

- Remain private for longer and defer their IPOs.
- Pursue other liquidity alternatives, such as acquisitions.
- Pursue listings on non-US securities exchanges.

The Jumpstart Our Business Startups Act (JOBS Act), enacted in April 2012, sought to redress the balance of regulation in the US and facilitate capital formation. Almost two years later, with improving economic conditions and new market practices having taken hold, a tipping point may have been reached in favour of US capital markets for foreign issuers. Following the JOBS Act, 2013 proved to be the strongest year for IPOs in the US since 2000:

- 197 IPOs were completed, raising approximately US$57 billion in offering proceeds.
- 37 of the above IPOs were undertaken by foreign issuers.

The vast majority of the above IPOs were undertaken by companies that were considered by the SEC to be emerging growth companies (EGCs) under the JOBS Act (*see below, Benefits of EGC status*).

However, despite these figures, it must be noted that issuers still rely heavily on private offerings, and the amount of capital raised in private offerings in the US continues to surpass that raised in registered offerings.

THE JOBS ACT: SUMMARY

The JOBS Act affects both exempt and registered offerings, as well as the reporting requirements for certain public issuers.

The centrepiece of the Act, as set out in Title I, is a new approach to IPOs, referred to as the "IPO on-ramp," for companies that can be categorised as EGCs. The on-ramp approach is intended to encourage EGCs to pursue IPOs by phasing in compliance measures over time.

In addition, the JOBS Act makes certain allowances for companies with EGC status, such as:

- Confidential SEC staff reviews of draft IPO registration statements.
- Scaled disclosure requirements.
- No restrictions on test-the-waters communications with qualified institutional buyers (QIBs) and institutional accredited investors before and after filing a registration statement.
- Fewer restrictions on research (including research by participating underwriters) around the time of an offering.

The provisions of Title I were immediately effective from 5 April 2012.

In addition to the changes made to the IPO process for companies that qualify as EGCs under Title I, the JOBS Act directs the SEC to:

- Amend its rules to eliminate the ban on general solicitation and general advertising in Rule 506 offerings when sales are only to accredited investors, along with comparable changes to Rule 144A (*Title II*).
- Establish a small offering exemption for crowdfunding (*Title III*).
- Create a new exemption for offerings up to US$50 million (*Title IV*).
- Raise the holder-of-record threshold for mandatory registration under the Securities Exchange Act of 1934, as amended (Exchange Act) (*Titles V and VI*) (these provisions were immediately effective).

Foreign issuers can benefit from all of these changes, except the ability to rely on crowdfunding.

THE IPO PROCESS FOR FOREIGN ISSUERS

Choice of offering

Foreign issuers considering accessing the US capital markets have a number of financing options. As a preliminary matter, a foreign issuer must choose between either a:

- Public offering in the US, which will subject the issuer to ongoing securities reporting and disclosure requirements.
- Limited offering in the US, which will not subject the issuer to US reporting obligations.

A public offering in the US offers distinct advantages for foreign issuers and a number of important benefits are available to foreign private issuers (FPIs).

Foreign private issuers (FPIs)

An FPI is any issuer (other than a foreign government) incorporated or organised under the laws of a jurisdiction outside of the US, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly by residents of the US, and any of the following applies:

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- The majority of the issuer's executive officers or directors are US citizens or residents.
- The majority of the issuer's assets are located in the US.
- The issuer's business is principally administered in the US.

Advantages for FPIs

Current SEC rules ease the disclosure burdens imposed on FPIs and reduce their ongoing costs of securities reporting obligations. In recent years the SEC (recognising that global markets have become increasingly integrated) has focused on reducing many of the burdens imposed on FPIs by US securities laws and corporate governance requirements, for example:

- Unlike a domestic issuer which faces a shorter time period, an FPI must file an annual report on Form 20-F within four months of the issuer's fiscal year-end.
- An FPI is not required to file quarterly reports or proxy solicitation materials in connection with shareholder meetings.
- An FPI is exempt from certain executive compensation disclosure requirements.
- The SEC and the securities exchanges make several important corporate governance allowances available to an FPI, generally allowing an FPI to rely on its home country practices.
- Foreign issuers are not subject to most of the governance requirements set out in the Dodd-Frank Act, such as mandatory say-on-pay votes.
- An FPI can prepare its financial statements in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board, without reconciliation to US generally accepted accounting principles (US GAAP).
- An FPI can exit the US capital markets and terminate the registration of a class of its securities under the Exchange Act more easily than a domestic issuer.

In addition, US domestic issuers are required to publicly file their initial registration statements and all subsequent registrations statements. However, FPIs can submit their initiation registration statements on a confidential basis to the SEC staff if they:

- Are listed or are concurrently listing their securities on a non-US securities exchange.
- Are being privatised by a foreign government.
- Can demonstrate that the public filing of the initial registration statement would conflict with the law of an applicable foreign jurisdiction.

Despite this, if an FPI is a shell company, a blank check company, or a company that has no or substantially no business operations, it is not permitted to use the confidential submission process.

An FPI that qualifies to submit its initial registration statement on a confidential basis benefits from receiving and resolving SEC staff comments on its confidential submissions prior to having the initial registration statement publicly filed. However, prior to commencing a road show (that is, a series of meetings with potential investors) or selling its securities, an FPI must file its registration statement publicly.

Following its first registration with the SEC, all subsequent registration statements submitted to the SEC by the FPI must be publicly filed. An FPI that qualifies as an EGC can use the confidential registration statement review procedures that are available to EGCs under the JOBS Act (*see below, Benefits of EGC status: Confidential submission to SEC*).

BENEFITS OF EGC STATUS

An EGC is a newly created category of issuer under the JOBS Act, which has certain advantages in relation to US securities laws. To qualify for EGC status, the company must have total annual gross revenues of less than US$1 billion (or the US dollar equivalent, calculated on a US GAAP or IFRS basis) during its most recently completed fiscal year. A company's EGC status will continue until the earliest of any of the following:

- The last day of the fiscal year during which it had total annual gross revenues of at least US$1 billion.
- The last day of the fiscal year following the fifth anniversary of the initial public offering of its equity.
- The date on which it has, during the previous three-year period, issued more than US$1 billion in non-convertible debt.
- The date on which it is considered to be a "large accelerated filer" under the Exchange Act.

The benefits of EGC status in the context of an IPO are set out below.

Confidential submission to SEC

The JOBS Act has liberalised the IPO process for EGCs. An EGC is permitted to submit a draft IPO registration statement for confidential review by the SEC prior to making a public filing, provided the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the EGC commences a road show.

A foreign issuer may have two confidential filing alternatives. It may qualify for the confidential submission process outlined above. Or, if it is an EGC, then it may avail itself of the EGC confidential submission process. As an EGC, the FPI would be subject to the requirement to make a public filing 21 days prior to roadshow commencement. However, this rule does not technically apply to non-EGCs that are foreign issuers and are entitled to submit their registration statements for confidential SEC review.

An EGC's confidentially submitted draft registration statement does not need to:

- Be signed by the issuer and its officers or directors.
- Contain a signed auditors' consent.

However, the statement must be fully completed, as the SEC may decide not to review a draft submission that is deemed incomplete or materially deficient.

There are few, if any, disadvantages to the confidential submission process. As a result, most EGCs have taken advantage of the confidential submission process. The issuer preserves the flexibility to proceed with the offering process without the glare of publicity and can proceed without competitors and others becoming aware of the proposed offering. The issuer will have greater flexibility to control the timing of the offering. If market conditions do not support an offering, the issuer may decide to delay the process and will not subject itself to public scrutiny for doing so. If the issuer needs to withdraw the filing, again, it will be able to do so without the stigma associated with a failed or withdrawn offering.

An issuer will often decide to pursue a dual-track approach, whereby it will decide to undertake an IPO and also consider M&A alternatives. Publicly available IPO filings can serve to stimulate interest on the part of potential acquirers. If an issuer were to choose the confidential submission approach, the confidential filing will not engender heightened interest in acquiring the company. However, there is no restriction on an EGC that would prevent it from disclosing that it has submitted a registration statement for confidential review. Several filers have done exactly that.

Disclosure requirements

Another advantage for EGCs is relaxed disclosure requirements. EGCs can therefore choose to provide:

- Two (rather than three) years of audited financial statements.
- A correspondingly reduced Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) in a registration statement related to its IPO.

Going forward, an EGC may elect to omit selected financial data and MD&A information for any period prior to the earliest period for which audited financial statements were presented in the IPO registration statement. An EGC will want to discuss with its counsel and other IPO advisers whether it should provide additional (optional) disclosures for prior periods. In some cases, an issuer may want to include information for prior periods for competitive reasons, or to illustrate a trend affecting its business.

Market experience continues to be mixed. To date, just over half of the EGCs that completed IPOs have included three years of financial statements in their filings. To the extent a foreign issuer already is listed and reporting in its home country, information for prior periods may be readily available and already published.

Testing-the-waters communications

The JOBS Act relaxes certain restrictions on communications prior to and during the offering process. The JOBS Act permits an EGC or a person acting on its behalf (whether before or after the filing of a registration statement) to "test the waters" and gauge market interest in a potential offering, by engaging in oral or written communications with potential investors that are QIBs or institutional accredited investors.

However, the issuer should still carefully consider the types of discussions that it will conduct while it is in registration, despite the more flexible rules. For example, an issuer will want to consider the types of information it is comfortable sharing, on a confidential basis, with institutional investors. Generally, test-the-waters meetings have taken place later in the offering process, once the issuer has obtained comments from the SEC on its confidential submission. Investors may prefer for such discussions to take place closer to the launch of the issuer's formal road show. Practices relating to test-the-waters communications are still evolving and can vary depending on the issuer's industry sector or business model (among other things).

Research coverage

The JOBS Act promotes research coverage of EGCs by relaxing many prohibitions relating to research that were adopted in the aftermath of the US "internet" or dotcom bubble in the early 2000s.

The JOBS Act permits investment banks to publish and distribute research reports about an EGC that may be conducting an IPO before it is filed, during the filing process or immediately after the filing.

The research report will not be deemed to constitute an "offer", even if the broker-dealer publishing the report is participating or will participate in the IPO.

The JOBS Act also relaxes many of the restrictions on communications between research and banking at investment banks to facilitate diligence or other discussions about EGCs. Certain investment banks subject to a court-ordered settlement relating to the conduct of research may be required to obtain further relief in order to benefit from the loosening of the prohibitions on joint research/banking communications.

Foreign issuers may be accustomed to pre-deal research reports in their home countries. However, US investment banks have not made much use of the ability to publish research prior to the completion of an issuer's IPO. Generally, underwriters have been commencing research coverage only after completion of the 25-day prospectus delivery period following the IPO.

Phase-in of governance requirements

For so long as an issuer remains an EGC, it can defer compliance with various governance requirements (including, in the case of a domestic US issuer, newly adopted say-on-pay and related provisions imposed by the Dodd-Frank Act).

EGCs are also not subject to the requirement for an auditor attestation of internal controls under section 404(b) of the Sarbanes-Oxley Act. To date, EGCs have disclosed their intention to rely on the exemption from the attestation requirement under section 404(b).

However, most of the other governance requirements remain in place for EGCs, such as:

- The requirements that manage, establish, maintain and assess internal controls over financial reporting.
- CEO and CFO certifications.

In addition, EGCs are not required to comply with any new or revised financial accounting standard until the date that such accounting standard becomes broadly applicable to private companies. Most EGCs have not taken advantage of this extended transition period for compliance with accounting standards.

EXEMPT OFFERINGS BY FOREIGN ISSUERS

Exemption from registration with SEC

Given the registration requirements applicable to issuers that choose to register their securities with the SEC (*see Practice Note: Registration Process: Overview*), many foreign issuers have sought to access the US capital markets through targeted financings that are exempt from the registration requirements of US securities laws. However, without registration in the US, a foreign issuer cannot offer its securities in either:

- A public offering (such as an offering that involves broad selling efforts).
- An offering that would reach US retail investors.

FPIs that are already US reporting companies may also choose to rely on exempt offerings to raise additional capital.

Regulation D was intended to facilitate capital formation by providing issuers with a safe harbour from the registration requirements under the Securities Act. Since Regulation D provides a non-exclusive safe harbour from registration, issuers that fail to satisfy the objective criteria of Regulation D may still be in a position to rely on the broader statutory private placement exemption under section 4(a)(2) (for an overview of the registration exemptions available to issuers conducting private placements, see *Practice Note: Section 4(a)(2) and Regulation D Private Placements*).

Over time, issuers have come to place great reliance on Rule 506 of Regulation D, which allows issuers to sell their securities in a private placement to an unlimited number of accredited investors, provided that issuers comply with the general requirements of Regulation D. Historically, Regulation D prohibited an issuer or any person acting on its behalf from using general solicitation or general advertising. Even prior to the JOBS Act, the SEC was considering whether this prohibition against general solicitation had become outmoded, given the prevalence of internet communications and use of social media.

As discussed above, the JOBS Act required the SEC to undertake rulemaking to relax the prohibition against general solicitation.

In July 2013, pursuant to section 201(a) of the JOBS Act, the SEC issued final rules, which became effective in September 2013, relaxing the prohibition on general solicitation and general advertising for certain private placements under Rule 506 of Regulation D and for Rule 144A offerings.

Rule 506(b) will continue to permit an issuer to conduct a private offering without using general solicitation or general advertising.

Under new Rule 506(c), general solicitation and general advertising are permitted, provided:

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

The SEC indicated in the final rules that "reasonable efforts" to verify investor status will be a fact-based, objective determination based on the SEC's prior principles-based guidance. The SEC also provided a supplemental, non-exclusive list of methods that may be used to satisfy the verification requirement.

The SEC also issued final rules regarding "bad actor" disqualification requirements for Rule 506 offerings, which prohibit issuers and related persons (such as the issuer's underwriters, placement agents, directors, officers or significant shareholders) from participating in exempt securities offerings if they have been convicted of or are subject to court or administrative sanctions for securities fraud or other violations of specified laws.

Securities sold pursuant to Rule 144A may be offered to persons other than a QIB, including by means of general solicitation or general advertising, provided the securities are sold only to QIBs or persons whom the seller, and any other person acting on behalf of the seller, reasonably believe to be QIBs.

Cross-border private placements

Many foreign issuers that are not US reporting companies rely on institutional debt placements as financing alternatives. An institutional debt placement can offer a cost-efficient financing alternative. Most investors in institutional private placements are US financial institutions, with insurance companies being the most common. In some cases, non-US institutional investors may also participate.

Typically, the issuer offers debt securities directly to a limited number of institutional investors through a placement agent. Though institutional private placements can be conducted by relying on Rule 144A, the issuers in these institutional debt offerings generally rely on section 4(a)(2). Practitioners may or may not rely on Rule 506 in connection with these transactions. The JOBS Act does not amend section 4(a)(2) of the Securities Act. Therefore, at the outset of a transaction the issuer and its advisers should consider whether the transaction will be conducted by relying on either:

- Rule 506, to take advantage of the additional flexibility to use general solicitation.
- Section 4(a)(2), in which case, no general advertising or general solicitation may be used.

Accredited investor crowdfunding

Investor matchmaking sites (that is, internet sites used to match or introduce potential investors to companies that might be interested in raising capital) have come to play a more significant role in capital formation in recent years. A foreign issuer may use one of the many matchmaking sites active in private offerings to raise capital in the US from accredited investors.

However, to avoid the requirement to register as a broker-dealer, a matchmaking site must limit the scope of its activities. Prior to the enactment of the JOBS Act, the SEC issued several no-action letters to matchmaking sites that sought relief from the requirement to register as broker-dealers. Section 201(b) of the JOBS Act provides further legal certainty for these entities. Under section 201(b), in the absence of other activities that would require registration, a matchmaking site is exempt from the requirement to register as a broker-dealer if the matchmaking site:

- Does not receive compensation based on the purchase or sale of securities.
- Does not handle customer funds or securities.
- Is not a "bad actor" (*see above, Exempt offerings by foreign issuers: Exemption from registration with SEC*).

However, as provided in section 201, an investor matchmaking site can perform the following functions:

- Maintain a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means.
- Provide ancillary services in connection with Rule 506 offerings, including:
  - due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, provided the services do not include investment advice or recommendations to issuers or investors for separate compensation;
  - the provision of standardised documents to the issuers and investors, provided the person or entity does not negotiate the terms of the issuance for and on behalf of third parties, and that issuers are not required to use the standardised documents as a condition of using the service.

The above rules only apply to the activities of matchmaking sites in Rule 506 offerings. Although many articles in the popular press refer to the use of the internet to offer securities in Rule 506 offerings to accredited investors as "crowdfunding" or "accredited investor crowdfunding," it is important to note that the transactions taking place on such sites do not rely on the exemption under section 4(a)(6) for crowdfunded offerings.

Rule 144A/Regulation S offerings

A foreign issuer can also conduct a Rule 144A offering. A Rule 144A offering may be structured as a:

- Standalone offering, for one-time users.
- Continuous offering programme, for frequent issuers.

The relaxation of the prohibition on general solicitation in the context of a Rule 144A offering may be helpful to foreign issuers. Many Rule 144A offerings or continuous offering programmes include a contemporaneous Regulation S offering component for sales to non-US persons. The SEC clarified that:

- An offshore offering under Regulation S will not be integrated with a concurrent offerings under Rule 144A.
- General solicitation conducted in connection with a Rule 144A offering will not be considered "directed selling efforts" under Regulation S, provided there is no specific reference to the Regulation S offering in the Rule 144A materials.

However, the prohibition against directed selling efforts in the US still applies to Regulation S-only offerings.

CONCLUSION

The return of the US IPO market cannot be attributed solely or even principally to the JOBS Act. Renewed economic confidence was essential to restart the equity capital markets.

However, recent IPOs have performed reasonably well, encouraging continued investor interest in IPOs. Now, almost two years since enactment of the JOBS Act, it is clear that we have reached some sort of tipping point, for the following reasons:

- Market participants have become comfortable with new IPO practices.
- Growing companies, and their venture and private equity backers, are once again considering IPOs as promising liquidity opportunities.
- Significant barriers, both real and perceived, posed by regulatory and compliance requirements for newly public companies and their officers and directors have been addressed by the IPO on-ramp approach.
- Interestingly, the JOBS Act has brought about a renewed interest in "hybrid" offering formats, such as Rule 144A offerings and exempt "private" offerings using general solicitation.
- The once restrictive communications rules that seemed artificial and were unfamiliar to foreign issuers have been relaxed, creating heightened interest in a wider range of capital-raising alternatives.

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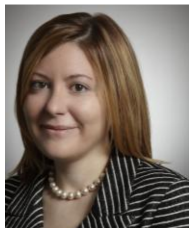

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Areas of practice. Securities and derivatives; investment banks/financial intermediaries; financing transactions, including public offerings and private placements of equity and debt securities, structured notes and other hybrid and structured products.

Recent transactions

- Major financial institutions acting as dealers and participants in the commodities and derivatives markets.
- Experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock, and off-balance sheet structures.
- Advised derivatives dealers regarding their internet sites and other internet and electronic signature/delivery issues, as well as on compliance matters.

Professional associations/memberships. Member of the American Bar Association's Committee on the Federal Regulation of Securities, a member of the subcommittee on Disclosure and Continuous Reporting; member of the subcommittee on Securities Registration; member of the task force on the future of securities regulation; member of the ABA Committee on Regulation of Futures and Derivatives Instruments; member of the George Washington University Center for Law, Economics & Finance Advisory Board; member of the Visiting Committee of the Law School of the University of Chicago.

Publications

- JOBS Act Quick Start, co-author, *International Financial Law Review*, 2013.
- Considerations for Foreign Banks Financing in the US, *International Financial Law Review*, 2012.
- Liability Management: An Overview, *International Financial Law Review*, 2011.
- Covered Bonds Handbook, co-author, *Practising Law Institute*, 2010.
- Co-author of the treatise *Exempt and Hybrid Securities Offerings*, *Practising Law Institute*, 2009, second edition 2011.
- BNA Tax and Accounting Portfolio, *SEC Reporting Issues for Foreign Private Issuers*, co-author, *BNA Accounting Policy and Practice Series*, 2009.

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- Represents issuers, including some of the nation's largest financial institutions, underwriters, agents, and other financial intermediaries, in public and private offerings of securities as well as issuers, investment banks, and purchasers in hybrid, mortgage-related, and derivative securities transactions.
- Developed some of the most widely used hybrid techniques for the placement and distribution of securities.
- Works closely with leading investment banks to formulate new methodologies for securities offerings and to structure innovative financial products. He has also represented many technology-based companies, including biotech and medical device companies.

Professional associations/memberships. Frequent lecturer on capital markets topics, and has lectured at the Securities and Exchange Commission, SIFMA and at a variety of securities industry groups. He lectures at law schools in the United States and abroad; served as an Editor of the University of Pennsylvania Law Review during his time in law school; served as Chairman of the Board of Trustees of Lehigh University and as National Chair of the Benjamin Franklin Society of the University of Pennsylvania.

Publications

- Covered Bonds Handbook, co-author, *Practising Law Institute*, 2010.
- Co-author of the treatise Exempt and Hybrid Securities Offerings, *Practising Law Institute*, 2009.
- BNA Tax and Accounting Portfolio, co-author, SEC Reporting Issues for Foreign Private Issuers, *BNA Accounting Policy and Practice Series*, 2009.
- Regulation of Financial Institutions, Financial Crises and Rescue Packages in Europe: the Iceland Case, co-author, chapter in Global Financial Crisis, *Globe Law and Business*, 2009.
- The Law: Legal and Regulatory Framework, co-author, PIPEs: A Guide to Private Investments in Public Equity, *Bloomberg*, 2006.