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Jumpstart Our Business Startups Act – Implications for Foreign Private Issuers

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act"). The stated objective for the JOBS Act is to increase job creation and economic growth in the United Stated by improving access to the public capital markets for startup and emerging companies, particularly for a newly defined class of emerging growth companies ("EGCs"). This legislation will relax or eliminate certain requirements in connection with securities offerings, reduce ongoing reporting obligations in the United States for ECGs and, potentially, lessen the broker-dealer regulatory requirements imposed on persons who participate in private placements. Some of the rule changes were effective upon enactment of the JOBS Act, while other changes will require rulemaking by the U.S. Securities and Exchange Commission (the "SEC"). For a complete overview of all provisions of the JOBS Act, please click here.[1]

The provisions of the JOBS Act apply to both U.S. and non-U.S. issuers, underwriters and placement agents. This alert summarizes those provisions that will be more relevant for foreign private issuers,[2] including changes to the initial public offering ("IPO") process for EGCs that may make it more appealing for qualifying foreign private issuers to pursue an IPO in the United States. In addition, this alert discusses the elimination of the ban on general solicitation for Regulation D and Rule 144A offerings and an increased exemption limit for small public offerings.

The "IPO On-Ramp" for Emerging Growth Companies

The JOBS Act creates a new classification of "emerging growth company" for domestic or foreign private issuers that have annual gross revenues of less than US$1 billion (an amount that is to be indexed for inflation every five years). This is a very high threshold, as it has been estimated that over 90% of companies that filed for IPOs in 2011 would have qualified as EGCs. A public issuer will remain an EGC until the earliest of:

(1) the last day of the fiscal year during which it had gross revenues of US$1 billion or more;

(2) the last day of the fiscal year following the fifth anniversary of its IPO;

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1 A copy of the JOBS Act, other Orrick client memos on various aspects of the JOBS Act, as well as links to various announcements, guidance and interpretations by the SEC (including the procedures for confidential submission of draft registration statements), can be found on our website at http://www.orrick.com/practices/corporate/jobs_act.asp.

2 The definition of "foreign private issuer" is set forth in Rule 3b-4 under the Securities Exchange Act of 1934. Foreign private issuers generally are subject to the requirements of that act, but are exempt from the provisions of Section 16 thereof (regulating insider reporting and short-swing profits).

(3) the date on which it has issued more than US$1 billion in nonconvertible debt during the previous three-year period;[3] or

(4) the date on which it becomes a "large accelerated filer" (i.e., has a public float greater than US$700 million).

As of the earliest of such dates, a public issuer must comply with all filing and reporting requirements applicable to non-EGCs. Additionally, a company may only qualify as an emerging growth company if its first offering of common equity pursuant to an effective registration statement occurred after December 8, 2011.

The JOBS Act simplifies the IPO process for EGCs by making the following significant changes to U.S. securities laws.

- **Confidential review of draft registration statements.** An EGC is permitted to submit a draft of its IPO registration statement for confidential review by the SEC prior to making a public filing. No filing fees are due at the time of the confidential submission, the draft does not need to be signed and no consents are needed from the auditors or any other experts. However, the draft of the registration statement must be substantially complete at the time of initial submission, including a signed audit report covering the fiscal years presented in the registration statement and exhibits. The Staff of the SEC has stated that it will defer review of any draft registration statement that is materially deficient. The confidential filing and any amendments would need to be included as exhibits to a publicly filed registration statement no later than 21 days before the issuer conducts a road show.

  We expect that most, if not all, EGCs will take advantage of this opportunity, which is a significant departure from current rules. This is a particularly welcome change for foreign private issuers that qualify as EGCs because in December 2011the SEC changed its longstanding policy of allowing all foreign issuers to submit initial registration statements to the SEC for review on a confidential basis and limited this ability to only certain types of foreign issuers. A foreign private issuer that qualifies as an EGC can now work out issues in its registration statement with the Staff without the public being aware that it is engaged in the IPO process.

- **"Testing the waters" communications with qualified institutional buyers and accredited investors.** The JOBS Act permits EGCs and their authorized representatives to communicate (orally or in writing) with qualified institutional buyers ("QIBS") and institutions that are accredited investors to determine whether such investors would have an interest in a contemplated securities offering. Such communications could take place before or after the filing of a registration statement and would not trigger the existing "gun-jumping" rules. This change will allow foreign private issuers to gauge market interest in their equity at an early stage in the IPO process. When combined with the new confidential submission process for EGCs, a foreign private issuer should be able to get a strong sense of the prospects for an IPO in the United States before needing to publicly announce its intentions to pursue one.

  Although there are many potential advantages to this change, there are some issues that must be considered. For example, there is no requirement that materials used in such communications be filed

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[3] The SEC has clarified that this should be interpreted as a rolling three-year period and include all debt securities issued by an EGC, whether in a registered offering or a private placement, but exclude other types of debt.

at any time with the SEC, which creates a potential risk that different information could be distributed to different groups of investors. These communications will remain subject to potential liability for any material misstatement or omission under the Securities Act of 1933, as amended (the "Securities Act"), or the general anti-fraud provisions of the securities laws. Certain members of the Staff have stated that they expect to ask issuers to provide them with any written testing the waters communications for their review. It is also unclear how advantageous this change will be for EGCs that are already public, as they will need to comply with Regulation FD, which prohibits selective disclosure by issuers of material nonpublic information.

- **Reduction in financial information to be included in SEC filings.** An EGC will only have to include two years of audited financial statements in its IPO registration statement, instead of the current three-year requirement. In any subsequent registration statement, an EGC will not need to present selected financial information or any management's discussion for any period prior to the earliest audited period presented in its IPO registration statement, as opposed to the five-year period generally required under the current rules. The Staff has clarified these reduced disclosure requirements also apply for foreign EGCs.

  While these advantages are enticing, EGCs will need to consider whether such reduced disclosure will affect the marketability and value of their securities when compared to companies that provide such information. Investors, particularly large investment companies, may play a role in setting market expectations for financial statement disclosure.

- **Exemption from auditor attestation of internal controls.** The JOBS Act provides an exemption for an EGC from the requirement under Section 404(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley") to obtain an attestation report on its internal controls for financial reporting from its auditors as long as it remains an EGC (i.e., up to five years). Such an attestation report is otherwise generally required between one and two years after a company becomes a public reporting company unless it qualifies as a smaller reporting company. EGCs will still need to comply with requirements under Sarbanes Oxley that they establish and maintain internal controls over financial reporting, provide an assessment by management of the effectiveness of such internal controls and have CEO and CFO certification of their financial statements.

  This change is expected to significantly reduce public company compliance costs for EGCs, as this auditor attestation has been seen as one of the more costly regulatory burdens under Sarbanes Oxley. However, the lack of an auditor attestation report could also negatively impact investor confidence, with a corresponding reduction in the value of a company's securities, when compared to similar companies that provide such reports. Some institutional investors may choose not to invest in public EGCs that do not include an auditor attestation of their internal controls at a time it would otherwise be required, and underwriting financial institutions may impose new diligence procedures for EGCs in light of the absence of such reports.

- **Exemption from new accounting standards and rules.** EGCs will not be subject to new or revised financial accounting standards until such standards apply to companies that are not reporting companies under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). An EGC may choose to comply with all standards applicable to other reporting companies but cannot choose to comply with only certain standards. The JOBS Act also provides that any rules of the Public Company Accounting Oversight Board ("PCAOB") requiring mandatory audit firm rotation or supplementary information about an audit and an issuer's financial statements will not apply to an audit of an EGC. Moreover, any additional rules adopted by the PCAOB following the date on which the JOBS Act is enacted will not apply to an EGC unless the SEC determines that such application is necessary for the public interest and has considered the protection of investors and whether the new requirement will promote efficiency, competition and capital formation.

- **Research reports from underwriting banks and analyst communications.** Investment banks are permitted under the JOBS Act to publish research reports during the pendency of a public offering (including IPOs) even if they act as underwriters, as such reports will not be deemed to constitute a regulated offer. The research analyst conflict of interest rules and "three-way" communication between research, investment banking and management will not apply to EGCs. Therefore, research analysts will be allowed to make appearances (such as at investor conferences or on TV shows) and participate in meetings with EGCs and their investment bankers. The SEC and the Financial Regulatory Authority ("FINRA") will not be able to impose rules that restrict such activities.

  Although pre-deal research and greater participation by research analysts in the offering process is fairly common in certain foreign markets, it is not yet clear to what extent the new flexibility granted by the JOBS Act will be utilized in the United States. Securities law liability under the Exchange Act will still apply to misleading research reports, and financial institutions could open themselves up to greater litigation and reputational risks. In addition, the contractual obligations of the 2003 Global Research Settlement still apply to several of the largest financial institutions, and it is unclear whether the SEC will seek to amend the settlement to even the playing field among the banks. This far, market commentators have speculated that banks may only take advantage of the rule changes to commence post-deal research earlier than the current 40-day waiting period and possibly reduce or eliminate the current 15-day ban on research before or after the expiration of a lock-up.

Elimination of Ban on General Solicitation and Advertising in Private Offerings

The JOBS Act requires the SEC to eliminate the prohibition against general solicitation or general advertising when conducting private placements under Rule 144A and Rule 506 of Regulation D. These significant changes will allow companies to advertise broadly when conducting private placements so long as securities are purchased only by QIBs (generally large institutions with over US$100 million of assets under management) or accredited investors (generally individuals with a net worth in excess of US$1 million, excluding personal residences), respectively. Consequently, the new legislation will allow advertisements for private offerings and will also allow private offerings to be conducted concurrently with public offerings. The JOBS Act also provides that with respect to securities offered and sold in compliance with Rule 506 no person who meets certain conditions shall be subject to registration as a broker or dealer solely because they take certain actions or perform certain services. The scope of this regulatory exemption, which is subject to SEC rulemaking, could expand the scope of permissible activities for "foreign broker-dealers" beyond those permitted under the exemption from registration provided by Rule 15a-6 under the Exchange Act. The applicability of the anti-fraud liability provisions under the Securities Act and Exchange Act to issuers and initial purchasers in connection with private offerings will remain the same.

The JOBS Act also requires that issuers take reasonable steps to verify that each purchaser in a Rule 144A or Rule 506 transaction relying on the new exemption is a QIB or an accredited investor, respectively. Depending on the implementing rules adopted by the SEC, the vetting process might prove challenging when issuers are permitted to advertise and solicit in a broad manner, particularly if done so over the Internet. Hopefully, the

SEC will incorporate into its new rules the well established industry practices which rely upon the completion of subscription documents and institutional certifications as to the status of prospective investors.

The JOBS Act provisions regarding general solicitation and advertising will not be effective until the SEC revises the applicable rules, with the JOBS Act calling for such rulemaking 90 days following its enactment, although the feasibility of the Staff meeting the timeline set by the legislation remains to be seen. As such, issuers must for now continue to comply with the ban on general solicitation and advertising in connection with Rule 506 and Rule 144A offerings.

Although "directed selling efforts" pursuant to Regulation S under the Securities Act have not been deemed to be "general solicitations," there remain questions regarding how the rule changes will work in conjunction with the prohibition on directed selling efforts in the United States in connection with offerings conducted pursuant to Regulation S. Until clarification is provided on this issue, the benefits of these changes may be significantly reduced for issuers that conduct offerings under both Rule 144A and Regulation S.

Increase in Exemption Limit for Small Offerings

The JOBS Act raises the limit for Regulation A (the small offerings exemption) offerings from US$5 million to US$50 million in any 12-month period and exempts Regulation A offerings from state securities laws, so long as the securities are (1) offered or sold over a national securities exchange or (2) sold to a "qualified purchaser." The revised Regulation A will require issuers to file audited financial statements annually with the SEC and the JOBS Act directs the SEC to develop rules relating to periodic disclosure by Regulation A issuers and to develop rules requiring an issuer to file and distribute to prospective investors an offering statement containing specified disclosures. This change will require SEC rulemaking, but no time limit was prescribed by the JOBS Act.

Next Steps for Foreign Private Issuers

The JOBS Act is still very much in its early stages. SEC rulemaking is required before general solicitation will be permitted in connection with Rule 506 and Rule 144A transactions, and the market will look to the SEC to identify the boundaries of the new regime. Even though the JOBS Act provisions applicable to the "IPO on-ramp" are already in effect, the SEC continues to release guidance and procedures that will assist EGCs and their advisors in navigating the IPO process in the United States. The market is also adjusting to the introduction of EGCs as issuers. Registration statements that have been filed by EGCs include disclosure of the potential investment risks associated with EGCs. Some EGCs have irrevocably elected to not avail themselves of the exemption from compliance with new or revised accounting standards. It remains to be seen to what extent investors will treat EGCs differently from other companies and the extent to which the package of JOBS Act regulatory reforms will "level the playing field" from the perspective of foreign private issuers considering whether to raise capital in the United States or in non-U.S. markets.

We plan to continue to monitor the adoption of the JOBS Act and further rulemaking by the SEC, FINRA, NYSE/NASDAQ and the PCAOB, and will provide periodic updates. We also expect that it will take some time for investment banks to review their guidelines and policies with respect to changes in the IPO process for companies that are likely to qualify as EGCs and we urge companies considering an IPO to seek the views of their bankers early on in their planning process.

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If you would like to receive additional information on any topic discussed in this publication, please contact your regular Orrick contact person any of the following:

AMERICAS

John V. Bautista
Silicon Valley
+1-650-614-7652
jbautista@orrick.com

Bruce Czachor
New York
+1-212-506-3750
bczachor@orrick.com

Karen Dempsey
San Francisco
+1-415-773-4140
kdempsey@orrick.com

Edward G. Eisert
New York
+1-212-506-3635
eeisert@orrick.com

Mitchell Zuklie
Silicon Valley
+1-650-614-7649
mzuklie@orrick.com

Stephen C. Ashley
New York
+1-212-506-3582
sashley@orrick.com

ASIA

Edwin Luk
Hong Kong
+852 2218 9138
eluk@orrick.com

William Woo
Hong Kong
+852 2218 9110
wwoo@orrick.com

EUROPE

Stephanie Bates
London
+44 20 7862 4706
stephanie.bates@orrick.com

Louis de Longeaux
Paris
+33 1 5353 7500
ldelongeaux@orrick.com

Jinal Shah
London
+44 20 7862 4613
jshah@orrick.com

David Syed
Paris
+33 1 5353 7500
dsyed@orrick.com

Hilary Winter
London
+44 20 7862 4605
hwinter@orrick.com