HINSHAW

Alerts

JOBS Act—SEC Guidance on Scaled Disclosure and Other EGC Issues

May 23, 2012
Hinshaw Alert

On April 5, 2012, President Obama signed the JOBS Act—a package of six bills designed to boost access to capital.

Among other things, the JOBS Act provides that emerging growth companies (EGCs) will be exempt from certain financial disclosure and governance requirements for up to five years. A *Corporate / Financial Institutions Alert* discussing all of the provisions of the JOBS Act may be found at http://www.hinshawlaw.com/congress-passes-jobs-act-in-effort-to-make-raising-capital-easier-04-02-2012/.

EGCs. Many companies are reluctant to undertake an initial public offering (IPO) because in doing so they will become subject to various U.S. Securities and Exchange Commission (SEC) rules and regulations thereafter.

The JOBS Act affords an EGC a temporary reprieve from certain SEC regulations by exempting the company from these regulations for up to five years. An EGC is defined as a company with total annual gross revenues of less than $1 billion in its most recently completed fiscal year. An EGC will retain such status until the earlier of: (1) the fifth anniversary of the date it first sold securities pursuant to an IPO registration statement; (2) the last day of the fiscal year in which it first exceeds $1 billion in annual gross revenues; (3) the time it becomes a large accelerated filer (an SEC-registered company with a public float of at least $700 million); or (4) the date on which the EGC has, within the previous three years, issued $1 billion of nonconvertible debt.

The SEC recently released two sets of FAQs concerning EGCs. These FAQs are discussed in this memo.

Regulatory Relief for EGCs. The JOBS Act provides scaled disclosure provisions for EGCs, including, among other things:

- permitting EGCs to include only two years of audited financial statements in the registration statement filed under the Securities Act of 1933 (the 1933 Act) for an IPO of common equity securities;
- allowing EGCs to comply with the smaller reporting company version of Item 402 of Regulation S-K; and
- removing the requirement that EGCs comply with Sarbanes-Oxley Act Section 404(b) auditor attestation of internal control over financial reporting.

Attorneys

Timothy M. Sullivan

Service Areas

Business & Commercial Transactions

Mergers & Acquisitions

Securities

Emerging Growth Company Revenue Test. An EGC is defined as a company with total annual gross revenues of less than $1 billion in its most recently completed fiscal year. The phrase "total annual gross revenues" means total revenues as presented on the income statement presentation under U.S. Generally Accepted Accounting Principles (GAAP). If the financial statements for the most recent year included in the company's registration statement are those of its predecessor, the predecessor's revenues would be used when determining if the company meets the EGC definition.

Calculating Total Annual Gross Revenues for Financial Institutions. When determining its "total annual gross revenues" for purposes of determining EGC status, a financial institution should use the same standard used to calculate smaller reporting company status. A financial institution would utilize the method approved for financial institutions found in Section 5110.2(c) of the Division of Corporation Finance's Financial Reporting Manual.

A financial institution must include all gross revenues from traditional banking activities. These revenues would include interest on loans and investments, dividends on investments, fees from loan origination, fees from trust and investment services, commissions, brokerage fees, mortgage servicing revenues, and any other fees or income from banking or related services. A financial institution would not have to include gains and losses on dispositions of investment portfolio securities (although it may include gains on trading account activity if that is a regular part of the institution's activities).

When Are Total Annual Gross Revenues Calculated. A company may not qualify as an EGC if it has total annual gross revenues of less than $1 billion in its most recently completed fiscal year. A company that had more than $1 billion in total annual gross revenues two years ago would be deemed an EGC if for its most recently completed fiscal year, the company's total annual gross revenues were less than $1 billion. The total annual gross revenues test focuses on the total annual gross revenues for the most recently completed fiscal year.

Termination of EGC Status. An EGC will lose its EGC status on the "last day of the fiscal year of the [EGC] following the fifth anniversary of the date of the first sale of common equity securities pursuant to an effective registration statement," provided that none of the three other disqualifying conditions (discussed above at *EGCs*) have previously been triggered.

This EGC would look to the fiscal year during which the fifth anniversary occurs. The last day of this fiscal year will be the first day that the company is a non-EGC, provided that none of the other disqualifying conditions have been triggered. For example, if an EGC with a December 31 fiscal year-end first sold common equity securities pursuant to an effective registration statement on May 2, 2012, it would cease to be an EGC no later than December 31, 2017.

Requalifying as an EGC. An EGC will lose this status prior to the fifth anniversary of its IPO if it satisfies any of the three disqualification provisions discussed above in *EGCs*. A company that qualified as an EGC may not regain its status as an EGC after losing that status pursuant to the disqualification provisions in the JOBS Act. The definition of EGC has no provision allowing a company to regain EGC status in this situation.

For example, a company will lose its EGC status on the last day of the fiscal year in which it has $1 billion in annual gross revenues. A company could not regain its EGC status if in the following fiscal year it has less than $1 billion in annual gross revenues.

Successor Companies as EGCs. A company that completes a transaction which results in it becoming the successor to its predecessor's SEC registration and reporting obligations cannot qualify as an EGC if its predecessor was not eligible to be an EGC because its first sale of common equity securities pursuant to an effective registration statement occurred on or before December 8, 2011.

EGC Effective Date. The JOBS Act provides that a company shall not qualify to be an EGC "if the first sale of common equity securities of such company pursuant to an effective registration statement" under the 1933 Act occurred on or before December 8, 2011.

The phrase "date of the first sale of common equity securities" under the JOBS Act could be:

- the date of a company's initial primary offering of common equity securities for cash;
- an offering of common equity pursuant to an employee benefit plan registered on a Form S-8; or
- a selling shareholder's secondary offering registered on a resale registration statement.

Even if its registration statement had been declared effective on or before December 8, 2011, a company may qualify as an EGC so long as the first sale of common equity securities occurs after December 8, 2011, assuming the company meets all of the other requirements of the EGC definition.

A company that qualifies as an EGC may amend its registration statement to provide the scaled disclosure available to EGCs even though the registration statement was initially filed prior to April 5, 2012. The filing may be made in a pre-effective amendment to a pending registration statement or in a post-effective amendment.

Disclosing EGC Status. When filing a draft registration statement, an EGC should disclose that it is an EGC on the cover page of its prospectus. This disclosure would be included in the confidential submission as well as the publicly filed registration statement.

An EGC should discuss its status in its prospectus and the risks associated with being an EGC. For example, an EGC should consider disclosing that it is exempt from the Sarbanes-Oxley auditor attestation rule and discuss the risks this may pose.

New Confidential Submission Procedures. An EGC may submit a confidential draft of a registration statement and related amendments to the SEC for non-public review. The initial submission and all amendments must be publicly filed with the SEC at least 21 days before the road show. The SEC previously indicated that an eligible EGC should file a confidential draft registration statement in a text searchable PDF file on a CD/DVD or in paper.

Effective May 14, 2012, the SEC replaced these confidential submission procedures with a secure email system.

Until the SEC is able to receive confidential draft registration statements on EDGAR, an EGC that submits a confidential draft of the registration statement must comply with these instructions on how to use the new secure e-mail system. All draft submissions must be in text searchable PDF format and include a transmittal letter identifying the EGC and the type of submission and confirming the company's EGC status.

Scaled Disclosure—Audited Financials, Selected Financial Data, MD&A and Ratio of Earning to Fixed Charges. As indicated above (*Regulatory Relief for EGCs*), an EGC may use the scaled disclosure provisions set forth in the JOBS Act. An EGC may elect to take advantage of some or all of these provisions and, if it chooses, to comply with the regular disclosure provisions (see, however, *Scaled Disclosures—Election to Comply With New or Revised Accounting Standards* below).

Under these provisions, an EGC need not present more than two years of audited financial statements in a registration statement for an IPO of its common equity securities. This section also provides that, "in any other registration statement to be filed with the Commission, an [EGC] need not present selected financial data in accordance with section 229.301 of title 17 . . . for any period prior to the earliest audited period presented in connection with its initial public offering." If an EGC presents two years of audited financial statements in its IPO registration statement, the number of years of selected financial data under Item 301 of Regulation S-K and the MD&A is limited to two years as well.

Technically, the JOBS Act provision permitting the filing of only two years of audited financial statements is limited to the registration statement for the EGC's IPO public offering registration statement. However, the SEC has determined that an EGC does not need to present in other registration statements audited financial statements for any period prior to the earliest audited period presented in connection with its IPO of common equity securities.

For certain offerings, Item 503(d) of Regulation S-K requires a company to present its ratio of earnings to fixed charges for each of the last five fiscal years and the latest interim period for which financial statements are presented in the registration statement. If Item 503(d) is applicable, an EGC may present in a registration statement its ratio of earnings to fixed charges for the same number of years for which it provides selected financial data disclosures.

Scaled Disclosures—Election to Comply With New or Revised Accounting Standards. An EGC may chose to take advantage of the extended transition period provided for complying with new or revised accounting standards. This provision allows EGCs to elect whether to comply with new or revised accounting standards, deferring compliance until it is no longer an EGC or until the standards are applicable to private companies.

The term “new or revised” financial accounting standard refers to any update issued by the Financial Accounting Standards Board (FASB) to its Accounting Standards Codification after April 5, 2012, the date of the enactment of the JOBS Act.

An EGC “must make such choice at the time the company is first required to file a registration statement, periodic report, or other report with the Commission” and notify the SEC of its decision at the time of such filing. EGCs that currently are in registration or are subject to Exchange Act reporting should make and disclose their choice in their next amendment to the registration statement or in their next periodic report, respectively.

The decision to opt out of the extended transition period is irrevocable.

If an EGC chooses to take advantage of the extended transition period, it can later decide to “opt in” (i.e., comply with the financial accounting standard effective dates applicable to non-EGCs). This decision should be prominently disclosed in the first periodic report or registration statement following the EGC’s decision and, once made, the decision is irrevocable.

An EGC choosing to take advantage of the extended transition period for complying with new or revised accounting standards should look to SEC Staff Accounting Bulletin (SAB) Topic 11M for disclosure guidance. For each recently issued accounting standard that will apply to its financial statements, an EGC that is taking advantage of the extended transition periods should disclose the date on which adoption is required for non-EGCs and the date on which the EGC will adopt the recently issued accounting standard, assuming it remains an EGC as of such date.

If an EGC decides not to take advantage of the extended transition period, it should:

- if using the confidential submission process, notify the SEC staff of its choice in the initial confidential submission;
- if currently in registration, disclose its choice in its next amendment to the registration statement; and
- if already subject to Exchange Act reporting, disclose its choice in its next periodic report.

Switching to Scaled Disclosure. A company that qualifies as an EGC and that has a registration statement that was initially filed before April 5, 2012, may switch to the scaled disclosure provisions available to EGCs in a pre-effective amendment to a pending registration statement or in a post-effective amendment. However, the SEC may seek other disclosures in response to the changed disclosure and EGCs should consider adding disclosure regarding the omitted information (for example, if the third year of audited financial statements removed represents poor financial results).

Financial Statements of Other Entities. In addition to presenting its own financial statements, an EGC may be required to present up to three years of financial statements of other entities in its registration statement, based on the significance of those entities (e.g., financial statements of acquired businesses).

If the significance test results in a requirement to present three years of financial statements for these other entities, an EGC need only present two years of financial statements for these other entities in its registration statement.

Material Error in Financial Statements. If, after the confidential submission of a draft registration statement, the EGC discovers a material error in one or more of its financial statements, the EGC should restate and confidentially submit a draft amendment to the registration statement to correct the error and disclose the restatement.

The EGC would be required to include the restatement disclosures in its financial statements until its financial statements are updated for the next annual period. ASC 250-10-50 requires that “when prior period adjustments are recorded, the resulting effects . . . on the net income of prior periods shall be disclosed in the annual report for the year in which the adjustments are made and in interim reports issued during that year subsequent to the date of recording the adjustments.” ASC 250-10-50 further states that “[f]inancial statements of subsequent periods shall not repeat the [restatement] disclosures.”

Nonconvertible Debt. The JOBS Act provides that an ECG will lose its EGC status on the “date on which such company has during the previous three-year period, issued more than $1,000,000,000 in non-convertible debt,” provided that none of the other EGC disqualifying conditions have been triggered.

The three-year period covers any rolling three-year period. It is not limited to completed calendar or fiscal year. As of any date on which a company has issued more than $1 billion in nonconvertible debt over the three years prior to such date, the company will lose its status as an EGC.

“Nonconvertible debt” means any nonconvertible security that constitutes indebtedness, whether issued in a registered offering or not.

Debt Securities—A/B Exchange Offer. A company may lose its EGC status if it issues, within a three-year period, $1 million of nonconvertible debt. An EGC may wish to issue publicly registered debt in exchange for debt acquired by investors in a private placement. The investors in the private placement receive the newly registered, freely tradeable debt securities in exchange for the debt securities they acquired in the private placement (A/B exchange offer).

In general, all nonconvertible debt securities issued over the three-year period, whether outstanding or not, are required to be counted against the $1 billion debt limit. Because debt securities issued in an A/B exchange offer are identical to (other than the fact that they are not restricted securities) and replace those issued in the nonpublic offering, the SEC views the A/B exchange offer as, in effect, the completion of the capital-raising transaction. Therefore, an EGC may exclude such the newly issued debt when determining whether it has exceeded the $1 billion debt limit. However, the old debt securities would be counted towards the $1 billion limit. Furthermore, debt securities issued in connection with the refinancing of existing debt would count towards the $1 billion debt limit.

The JOBS Act allows an EGC to submit a confidential draft of its registration statement. An EGC contemplating an A/B exchange offer may use the confidential submission process to submit a draft registration statement for the offer on Form S-4. As with an IPO registration statement, an EGC must publicly file the Form S-4 for its A/B debt exchange offer at least 21 days before its anticipated date of effectiveness.

EGCs With Publicly Issued Debt. A company that has issued only debt securities pursuant to an effective registration statement on or before December 8, 2011, may qualify as an EGC if its annual total gross revenues for its most recently completed fiscal year were less than $1 billion and none of the four disqualifying conditions (discussed above at EGCs) have been triggered. The effective date for the definition of EGC focuses only on whether the first sale of common equity securities pursuant to an effective registration statement occurred on or before December 8, 2011.

Asset Backed Securities (ABS) Companies. An ABS company is a company, usually a trust, that acquires and holds a discrete pool of financial assets, such as credit card receivables, car leases or loans that by their terms liquidate over a specified time period. ABS companies are subject to an entirely separate disclosure and reporting regime under Regulation AB that is designed to address their particular structure and operations.

An ABS company may not qualify as an EGC.

Registered Investment Companies. Registered investment companies are externally managed pooled investment vehicles that are subject to an entirely separate disclosure and reporting regime that is designed to address their particular structure and operations.

An investment company registered under the Investment Company Act may not qualify as an EGC.

Business Development Companies (BDCs). BDCs, a category of closed-end investment companies that are not required to register under the Investment Company Act but are regulated pursuant to Sections 55 through 65 of that act, may qualify as EGCs.

BDCs may register as an EGC.

Conflicts With SEC Rules. Certain provisions of the JOBS Act conflict with SEC form requirements, Regulation S-X and Regulation S-K.

An EGC may comply with the JOBS Act disclosure provisions in its registration statements, periodic reports and proxy statements, even if doing so would be inconsistent with existing rules and regulations. The disclosure provisions in the JOBS Act supersede, in relevant part, existing rules and regulations.

For example, Section 102(c) of the JOBS Act, which was not enacted as part of the Exchange Act, provides that an EGC may comply with Item 402 of Regulation S-K by providing only the information required of a smaller reporting company, even if it does not qualify as a smaller reporting company. In addition, Section 103 of the JOBS Act, which also was not enacted as part of the Exchange Act, provides that an EGC is not required to comply with the requirements of Sarbanes-Oxley Section 404(b).

An EGC's CEO and CFO are required to certify in their Sarbanes-Oxley Act Section 906 certifications that the company's periodic report fully complies with the requirements of Sections 13(a) or 15(d) of the Exchange Act.

Release of Comment Letters and EGC Responses. Under the SEC's Rule 83, a company may request that certain information be kept confidential. An EGC filing its draft confidential registration statement does not have to request that the registration statement be kept confidential. However, the draft registration statement and all amendments thereto must be publicly filed if the EGC moves forward with its IPO.

The SEC will publicly release its comment letters and EGC responses to staff comment letters on EDGAR no earlier than 20 business days following the effective date of a registration statement. An EGC seeking to keep confidential treatment for certain information should make a Rule 83 request identifying information for which it intends to seek confidential treatment when it submits its responses to staff comments on confidential draft registration statements.

Compliance with XBRL Requirements. The SEC requires companies to comply with its eXtensible Business Reporting Language (XBRL) which is part of the SEC's family of interactive data reporting standards. EGCs must comply with XBRL requirements.

Foreign Private Issuers. An EGC is defined as an issuer with total annual gross revenues of less than $1 billion in its most recently completed fiscal year as reported under U.S. GAAP (or International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), if used as the basis of reporting by a foreign private issuer). If a foreign private issuer's financial statements are presented in a currency other than U.S. dollars, total annual gross revenues should be calculated in U.S. dollars using the exchange rate as of the last day of the most recently completed fiscal year.

If a foreign private issuer comes within the definition of an EGC, it may use the confidential submission procedure to the same extent as a domestic EGC. Qualifying foreign private issuers must submit the draft registration statement in the same manner and to the same address as domestic EGCs.

If the foreign private issuer chooses to take advantage of any benefit available to EGCs, then it will be treated as an EGC and required to publicly file its confidential submissions at least 21 days before the road show. If the foreign private issuer chooses not to take advantage of any emerging growth issuer benefits, then it may follow the SEC's Policy on Non-Public Submissions from Foreign Private Issuers.

A foreign private issuer that qualifies as an EGC may comply with the scaled disclosure provisions available to EGCs to the extent relevant to the form requirements for foreign private issuers.

A foreign private issuer that qualifies as an EGC that reconciles its home country GAAP financial statements to U.S. GAAP may take advantage of the extended transition period for complying with new or revised financial accounting standards in its U.S. GAAP reconciliation until they are applicable to private issuers. If a foreign private issuer elects not to take advantage of this provision, it may not revoke this election.

Some non-U.S. jurisdictions have a separate set of financial accounting standards for nonpublic entities. If a foreign private issuer qualifies as an EGC and has chosen to take advantage of the extended transition period for complying with new or revised financial accounting standards in its U.S. GAAP reconciliation, the foreign private issuer may not apply the set of standards for nonpublic entities.

Foreign Private Issuers—Canadian Companies. A Canadian company filing under the Multi-Jurisdictional Disclosure System (MJDS) may qualify as an EGC.

However, the disclosure requirements for a Canadian EGC would continue to be established under its home country standards in accordance with the MJDS. Other provisions of Title I, such as the test-the-waters provision in Section 5(d) of the Securities Act and the deferral of compliance with Section 404(b) of the Sarbanes-Oxley Act, would be available to an MJDS filer that qualifies as an EGC.

For further information, please contact Tim Sullivan, Michael D. Morehead or your regular Hinshaw attorney.

Download PDF

This alert has been prepared by Hinshaw & Culbertson LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship.