SULLIVAN & CROMWELL LLP

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House Capital Formation Legislation

House of Representatives Passes the "JOBS and Investor Confidence Act of 2018"—a Package of Bipartisan Bills Addressing Capital Formation

On July 17, the U.S. House of Representatives voted 406 to 4 to pass **S. 488**, the "JOBS and Investor Confidence Act of 2018," which is "comprised of 32 individual pieces of legislation that have passed the House Financial Services Committee or the House this Congress with broad bipartisan support."[1] The House Financial Services Committee characterizes the legislation as "the third and largest installment of 'Jumpstart Our Business Startups (JOBS) Act' legislation aimed at helping small businesses, entrepreneurs and investors by reforming our capital markets."[2]

Among other measures, the bill would, if enacted, "help entrepreneurs access the capital they need to launch their companies and to go and stay public,"[3] by:

- Expanding to all public companies certain provisions of Title I of the JOBS Act that currently allow EGCs to (1) submit draft registration statements for IPOs to the SEC for confidential review before publicly filing, and (2) "test the waters" before filing a registration statement for an IPO;
- Modernizing the definition of "accredited investor" in Section 2(a)(15) of the Securities Act of 1933;[4]
- Amending Section 404(b) of the Sarbanes-Oxley Act to extend the exemption from the requirement that a public company's auditor attest to management's assessment of internal controls over financial reporting to certain former EGCs with less than $50 million in annual revenues;[5]
- Requiring the SEC to conduct a cost-benefit analysis of the requirement that public companies use Form 10-Q for submitting quarterly reports—including the costs and benefits to investors and other market participants—as well as the expected impact of the use of alternative formats of quarterly reporting for EGCs;
- Requiring the SEC, in consultation with FINRA, to study the direct and indirect costs associated with undertaking IPOs for small and medium-sized companies;

- Adding provisions designed to facilitate "demo days," that would allow start-ups to make presentations to interested potential investors under specified conditions without violating Regulation D restrictions on general solicitation; and
- Requiring issuers with a multi-class share structure to make certain disclosures intended to provide greater transparency regarding certain shareholders' voting power in any proxy or consent solicitation materials.

Each of these provisions is discussed in greater detail below. The legislation now moves to the Senate, where it could take several different procedural paths. If passed by the Senate without further amendment, the bill would go directly to the President for his signature. White House Press Secretary Sarah Huckabee Sanders expressed President Trump's support for the legislation but noted that the White House would seek "several technical and substantive changes."[6] After the House acted, Senate Majority Leader Mitch McConnell stated "[n]ow that the House has passed their bipartisan legislation to improve access to capital for communities across the country as they grow and create jobs, senators will continue their ongoing bipartisan discussions as we work towards a vote in the coming months."[7] Accordingly, although procedural and political hurdles remain, especially in the Senate, we believe the House-passed bill—or legislation substantially similar to that bill—stands a reasonably good chance of enactment before the end of this Congress.

Encouraging Capital Formation

If enacted, among the numerous capital formation-related initiatives, the bill would:

- ***Expand the testing the waters and confidential submissions provisions to all issuers.*** Currently, a provision in Section 5(d) of the Securities Act of 1933 allows emerging growth companies ("EGCs") to "test the waters" by engaging in "oral or written communications with potential investors … to determine whether such investors might have an interest in a contemplated securities offering, either prior to or following the date of filing of a registration statement with respect to such securities with the [SEC]." Another provision, in Section 6(e) of the Securities Act, allows EGCs to confidentially submit a draft registration statement "for confidential nonpublic review by the staff of the [SEC] prior to public filing." Although both of these provisions are restricted to EGCs, since July 2017, the SEC has accepted voluntary draft registration statement submissions from all issuers for nonpublic review. The bill would expand the application of these two provisions to all issuers, subject to any terms, conditions or requirements the SEC may impose by regulation on an issuer (other than an EGC) using this provision.
- ***Modernize the definition of "accredited investor" in the Securities Act.*** The "accredited investor" definition is an "essential component" of the SEC's Regulation D, "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investments or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary."[8] The bill would add two new prongs to the statutory definition and require the SEC to revise the definition in Regulation D to conform with these amendments.[9] The proposed amendments would add to the definition of accredited investor any natural person who:
  - Is currently licensed or registered as a broker or investment advisor by the SEC, FINRA, or an equivalent self-regulatory organization or a state division responsible for licensing or registration of individuals in connection with securities activities; or
  - The SEC determines, by regulation, to have demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment, and

whose education or job experience is verified by FINRA or an equivalent self-regulatory organization.[10]

- ***Extend the exemption from compliance with SOX 404(b) to certain former EGCs.*** The Sarbanes-Oxley Act (often referred to as "SOX") requires the management of a public company to assess the effectiveness of its internal controls for financial reporting. SOX Section 404(b) requires a public company's auditor to attest to, and report on, management's assessment of its internal controls, but currently exempts small issuers (*i.e.*, an issuer that is neither a "large accelerated filer" nor an "accelerated filer" as defined in Rule 12b-2).[11] The bill would amend SOX Section 404 by adding an additional exemption for "low-revenue" issuers (*i.e.*, an issuer that is no longer an emerging growth company[12] but has average annual gross revenues[13] of less than $50 million and is not a large accelerated filer). An issuer would no longer be eligible for the exemption at the earliest of (1) the last day of its fiscal year following the tenth anniversary of its initial public offering ("IPO"), (2) the last day of its fiscal year during which the average annual gross revenues of the issuer exceed $50 million, or (3) the date on which the issuer becomes a large accelerated filer.

- ***Require the SEC to undertake a cost-benefit analysis of continued use of Form 10-Q for quarterly financial reporting.*** The federal securities laws require publicly traded domestic issuers to submit quarterly reports on Form 10-Q, which call for unaudited financial statements and up-to-date information on the company's financial position during the year. A Form 10-Q must be filed for each of the first three fiscal quarters of the company's fiscal year. The bill would require the SEC to issue a report to Congress, within 180 of the bill's enactment, with an analysis of the costs and benefits of requiring reporting companies to use Form 10-Q for submitting quarterly reports, including the costs and benefits of Form 10-Q to:
    - EGCs;
    - The SEC, in terms of its ability to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation; and
    - Other reporting companies, investors, market researchers, and other market participants.
    - This analysis must specifically consider costs and benefits associated with (1) the public availability of information required to be filed on Form 10-Q, (2) the use of a standardized reporting format across all classes of reporting companies, and (3) the quarterly disclosure by some companies of financial information in formats other than Form 10-Q, such as a quarterly press releases.

- ***Require the SEC to study the costs associated with IPOs for small and medium-sized companies.*** The bill would require the SEC, in consultation with FINRA, to study the direct and indirect costs associated with small and medium-sized companies to undertake IPOs and to issue a report to Congress on its findings and determinations within 360 days of the enactment of the bill.
    - With respect to costs, the SEC would be required to specifically consider fees (such as gross spreads paid to underwriters, IPO advisors, and other professionals), compliance with Federal and State securities laws at the time of the IPO, and any other IPO-related costs the SEC determines appropriate.
    - The SEC would also be required to compare and analyze the costs of an IPO with the costs of obtaining alternative sources of financing and liquidity, and the impact of such costs on capital formation and the availability of public securities of small and medium-sized companies to retail investors.
    - The bill would also require the SEC to analyze trends in IPOs over an appropriate time period to analyze IPO pricing practices, considering (1) the number of IPOs, (2) how costs for IPOs have evolved over time, including fees paid to underwriters, investment advisory firms, and other professionals for services in connection with an IPO, (3) the number of brokers and dealers active in underwriting IPOs, (4) the different types of services that underwriters and related persons provide before and after a small or medium-sized company IPO and the factors impacting

underwriting costs, (5) changes in the costs and availability of investment research for small and medium-sized companies, and (6) any other consideration the SEC considers necessary and appropriate.

- ***Allow start-ups to make presentations to interested potential investors without violating Regulation D restrictions on general solicitation and advertising.*** The bill would require the SEC to amend the requirements of Regulation D—with respect to presentations and communications, but not with respect to purchases or sales—to require "that in carrying out the prohibition against general solicitation or general advertising,"[14] the prohibition will not apply to "a presentation or other communication made by or on behalf of an issuer" that is made at an event (referred to as a "demo day"):
    - Sponsored by (1) the United States or any U.S. territory, any State or the District of Columbia (including a political subdivision, agency, or instrumentality of any of these); (2) an institution of higher education, (3) a nonprofit organization, (4) an "angel investor group" (as defined below), (5) a venture forum, venture capital association, or trade association, or (6) any other "group, person or entity as the [SEC] may determine by rule;"
    - Where any advertising for the event does not reference any specific offering of securities by the issuer;
    - The sponsor of which (1) does not make investment recommendations or provide investment advice to attendees, (2) does not engage "in an active role" in any investment negotiations between the issuer and any investors attending the event, (3) does not charge event attendees any fees other than administrative fees, (4) does not receive any compensation for making introductions between investors attending the event and issuers, or for investment negotiations between such parties, (5) makes readily available to attendees disclosure "not longer than 1 page in length, as prescribed by the [SEC]," describing the nature of the event and the risks of investing in the issuers presenting at the event, and (6) does not receive any compensation with respect to the event that would require registration of the sponsor as a broker or dealer under the Securities Exchange Act of 1934, or as an investment advisor under the Investment Advisors Act of 1940; and
    - Where no specific information regarding an offering of securities by the issuer is communicated or distributed by or on behalf of the issuer, other than (1) that the issuer is in the process of offering securities or planning to offer securities, (2) the type and amount of securities being offered, (3) the amount of securities being offered that have already been subscribed for, and (4) the intended use of proceeds of the offering.
    - "Angel investor group" would be defined in the act as any group that (1) is composed of accredited investors interested in investing personal capital in early-stage companies, (2) holds regular meetings and has defined processes and procedures for making investment decisions, either individually or among the membership of the group as a whole, and (3) is neither associated nor affiliated with brokers, dealers, or investment advisors.
    - The bill would also provide that attendance at an event described above would not qualify, by itself, as "establishing a pre-existing substantive relationship between an issuer and a purchaser" for purposes of Rule 506(b) of Regulation D.
- ***Require issuers with a multi-class share structure to make certain disclosures to provide greater transparency regarding certain shareholders' voting power in any proxy or consent solicitation materials.*** The bill would amend Section 14 of the Securities Exchange Act of 1934[15] by adding a provision requiring issuers with multi-class share structures[16] to disclose, with respect to directors, director nominees, named executive officers, and beneficial owners of 5% or more of the total combined voting power of all classes of voting securities:[17]

- The number of shares of all classes of voting securities beneficially owned by such person, expressed as a percentage of the total number of the outstanding voting securities of the issuer; and

- The amount of voting power held by such person, expressed as a percentage of the total combined voting power of all classes of voting securities of the issuer.

- ***Require the SEC to study whether amendments to Rule 10b5-1 are necessary to prevent corporate insiders from indirectly engaging in insider trading through changes to trading plans.*** The bill would require the SEC to study whether Rule 10b5-1 should be amended to limit the ability of corporate insiders to adopt, modify or cancel trading plans (or adopt multiple, "overlapping" trading plans) during "issuer-adopted trading windows."

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ENDNOTES

[1] House Financial Services Committee, Press Release, House Passes Bipartisan "JOBS & Investor Confidence Act" (Jul. 17, 2018), *available at* https://financialservices.house.gov/news/email/show.aspx?ID=7UD3NQFEEE64BPYFPVE5Z6WSBQ (hereafter, the "HFSC Press Release").

[2] HFSC Press Release.

[3] HFSC Press Release.

[4] Securities Act of 1933 (15 U.S.C. §§ 77a *et. seq.*), *available at* http://legcounsel.house.gov/Comps/Securities%20Act%20Of%201933.pdf.

[5] A company qualifies as an EGC, as defined in Section 2(a)(19) of the Securities Act, if it has total annual gross revenues less than $1.07 billion during its more recently completed fiscal year and has not sold common equity securities under a registration statement. A company continues to be an EGC for the first five fiscal years after it completes an IPO unless (1) its total annual gross revenues are $1.07 billion or more, (2) it has issued more than $1 billion in non-convertible debt in the past three years, or (3) it becomes a "large accelerated filer" as defined in Exchange Act Rule 12b-2.

[6] *See* White House, Statement from the Press Secretary on the Passage of S.488 (Jul. 17, 2018), *available at* https://www.whitehouse.gov/briefings-statements/statement-press-secretary-s-488-jobs-investor-confidence-act-2018/.

[7] Lane, Sylvan, The Hill, "House passes bipartisan bill to boost business investment" (Jul. 17, 2018), *available at* http://thehill.com/business-a-lobbying/397528-house-passes-bipartisan-bill-to-boost-business-investment.

[8] Securities and Exchange Commission, *Report on the Review of the Definition of "Accredited Investor"* at 2 (Dec. 18, 2015), *available at* https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf (internal quotations and citations omitted) (hereafter, the "2015 SEC Staff Report").

[9] The Regulation D definition of "accredited investor" is codified at 17 C.F.R. 230.501 *et seq.*

[10] These amendments can be viewed in light of the 2015 SEC Staff Report reviewing the accredited investor definition for potential modification or adjustment, required by the Dodd-Frank Act to be completed every four years. The report considers alternative approaches to defining "accredited investor," provides staff recommendations for potential updates and modifications to the existing definition, and analyzes the impact potential approaches may have on the pool of accredited investors, including with respect to potential adjustments to the Regulation D income and net worth standards as well as potential new criteria.

The report recommended that the SEC revise the financial thresholds requirements for natural persons to qualify as accredited investors by (1) retaining the current income and net worth thresholds, subject to "investment limitations" for individuals who qualify as accredited investors "solely based on those thresholds" to a percentage of their income or net worth, (2) adding new inflation-adjusted income and net worth thresholds that are not subject to investment limitations, and (3) indexing all financial thresholds in the definition for inflation going forward. 2015 SEC Staff Report, at 89-91. The report also recommended that the SEC revise the definition of accredited investor "to allow individuals to qualify as accredited investors based on other measures of sophistication," including by permitting individuals to qualify because they (1) have a minimum amount of investments, (2) have certain professional credentials, (3) have experience investing in exempt offerings, (4) are employees of private funds (to qualify with respect to investments in their employer's funds), or (5) pass an "accredited investor examination." 2015 SEC Staff Report, at 93-96.

[11] 17 C.F.R. § 240.12b-2.

ENDNOTES (CONTINUED)

[12] That is, an issuer that is no longer an EGC because it has passed the last day of its fiscal year following the fifth anniversary of the date of its first sale of common equity pursuant to a registration statement.

[13] "Average annual gross revenues" is defined in the bill as the total gross revenues of an issuer over its most recently completed three fiscal years divided by three.

[14] 17 C.F.R. § 230.502.

[15] 15 U.S.C. § 78n.

[16] "Multi-class share structure" is defined in the bill as a capitalization structure that contains two or more classes of securities that have different amounts of voting rights in the election of directors.

[17] "Voting securities" in this context refers to classes of securities of the issuer entitled to vote in the election of directors.

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