GIBSON DUNN

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EFFORTS TO STRENGTHEN U.S. PUBLIC CAPITAL MARKETS CONTINUE - NEW SIFMA REPORT PROVIDES RECOMMENDATIONS TO HELP MORE COMPANIES GO AND STAY PUBLIC

To Our Clients and Friends:

On April 27, 2018, the Securities Industry and Financial Markets Association ("SIFMA"), the leading industry group representing broker-dealers, banks and asset managers, along with other securities industry related groups, released a report called "Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public" (the "Report").[1] In response to the decline in the number of IPOs and the number of public companies generally in the United States over the last twenty years, the Report provides recommendations aimed at reducing perceived impediments to becoming and remaining a public company.

As the Report notes, the United States is now home to only about half the number of public companies that existed 20 years ago. This decline is believed to have had adverse repercussions for the American economy generally, and the jobs market specifically. For example, the Report cites a 2010 study by IHS Global Insight suggesting that, generally speaking, 92% of a company's job growth occurs after it completes an IPO.[2] In addition, the growth of private capital markets at the expense of public capital markets has raised concerns that individual investors are being marginalized. More specifically, as many of the most innovative companies in the U.S. stay private longer and raise significant amounts of capital privately, the returns generated by such companies appear to accrue disproportionally to institutional, high net worth and other similar investors. As Securities and Exchange Commission (the "SEC") Chairman Jay Clayton noted in a July 2017 speech, "*the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of main street investors will be unable to participate in their growth. The potential lasting effects of such an outcome to the economy and society are, in two words, not good*."

To remedy this decline, the Report makes recommendations in five areas:

1. enhance several provisions of the Jumpstart Our Business Startups Act (the "JOBS Act");
2. encourage more research on emerging growth companies ("EGCs")[3] and other small public companies;
3. improve certain corporate governance, disclosure, and other regulatory requirements;
4. address concerns relating to financial reporting; and
5. tailor the equity market structure for small public companies.

1. Enhancing the JOBS Act

Over the past six years, the JOBS Act has demonstrated that rules and regulations around capital raising can be modernized while maintaining investor protections. Its accomodations have been widely adopted. The Report sets forth four recommendations to further enhance some of the key provisions of the JOBS Act:

- Extend Title I "on-ramp provisions."
  - The JOBS Act Title I "on-ramp" provisions provide a number of significant benefits to EGCs, including confidential review of registration statements and streamlined financial and executive compensation disclosure requirements, among others. The Report recommends that the benefits available to EGCs be extended from 5 years to 10 years after a company goes public. The "on-ramp" provisions have been widely utilized by EGCs since enactment. By increasing the length of time these benefits are available, the Report argues that even more companies may consider going public.
- Expand the "testing the waters" exemption to all issuers.
  - The Report recommends that Section 5(d) of the Securities Act of 1933 (the "Securities Act") be modified to permit all issuers, not just EGCs, to engage in "testing the waters" communications with qualified institutional buyers ("QIBs") or institutional accredited investors to determine interest in a securities offering. Consistent with this, in April 2018, SEC Director of Corporation Finance Bill Hinman reported to a congressional committee that the SEC is planning to expand the "testing the waters" benefit to all companies. This change would allow companies to better understand investor interest prior to undertaking the expense of an IPO.
- Increase exemption for reporting on adequacy of internal controls from 5 to 10 years for EGCs.
  - The JOBS Act gives EGCs a five-year exemption from Section 404(b) of the Sarbanes-Oxley Act, which requires external auditors to attest to the adequacy of the company's internal control on financial reporting. The Report recommends that this be extended from 5 years to 10 years for EGCs that have less than $50 million in revenue and less than $700 million in public float. This change is designed to ensure that internal control reporting requirements, and associated costs, are appropriately scaled to the size of the company.
- Remove "phase out" rules relating to EGC status.
  - The Report argues that the "phase out" rules related to EGC status should be removed, specifically given the overlap in certain status designations (*e.g.*, companies who qualify as both a large accelerated filer and an EGC face uncertainty as to their status after going public. See Section 4 below). Instead, issuers should be allowed to maintain their EGC status based on the JOBS Act definition. The Report suggests that the SEC could still set a public float or other threshold requirement to limit the size of company that could benefit from the change in phase out triggers.[4]

2. Encourage More Research

Research coverage can increase interest from investors in a company, and a lack of research coverage can adversely impact liquidity for certain companies. However, the Report notes that 61% of all companies listed on a major exchange with less than a $100 million market capitalization have no research coverage. To address this disparity, the Report makes the following three recommendations:

- Amend the Securities Act Rule 139 research safe harbor to allow continuing research coverage for all issuers during an offering.
  - The Report recommends that Rule 139 of the Securities Act be amended to provide that continued research analyst coverage does not constitute an offer or sale of securities, before, during, or after an offering by such issuer, regardless of whether the publishing broker-dealer is also an underwriter in the offering. Currently, only issuers who are eligible to use Form S-3 qualify for the Rule 139 safe harbor. As the Report notes, if an analyst has already been covering an issuer, there is no obvious logic to distinguishing companies that are S-3 eligible for the purposes of research coverage.
- Allow investment banking and research analysts to attend "pitch" meetings together.
  - While the JOBS Act permits investment banks and analysts to jointly attend pitch meetings, given other restrictions on the content of what those discussions may contain, bankers and analysts typically refrain from jointly attending pitch meetings with IPO candidates. The Report proposes that the SEC consider the removal of barriers prohibiting investment banks and analysts from jointly attending these meetings, as long as no direct or indirect promise of favorable research is given. The Report also endorses reviewing the 2003 global research settlement between many large investment banks and the SEC, self-regulatory organizations, such as Financial Industry Regulatory Authority ("FINRA"), and other regulators regarding research analyst conflicts of interest (the "Global Research Settlement"). The Global Research Settlement precludes settling firms from having research analysts attend EGC IPO pitch meetings, irrespective of the regulatory easing afforded by the JOBS Act.[5]
- Investigate why pre-IPO research remains limited.
  - Despite the liberalization of "gun jumping" rules related to research as part of the JOBS Act, the Report states that very few investment banks have published any pre-IPO research. The Report urges the SEC to investigate why the JOBS Act has not led to an increase in pre-IPO research. This may be due to existing FINRA rules, the Global Research Settlement, and federal and state law liability concerns. The Report advocates for the SEC to examine this issue in an effort to increase pre-IPO research coverage.

3. Improve Certain Corporate Governance, Disclosure and other Regulatory Requirements

According to the 2011 IPO Task Force, a group convened in response to a capital access roundtable sponsored by the Department of the Treasury, 92% of U.S. public company CEOs have found the "administrative burden of public reporting" to be a significant barrier to completing an IPO. In addition, pressure from activist investors (often supported by proxy advisory firms) can distract management from carrying out their management duties, which in turn costs shareholders. In response to these and other pressures, the Report recommends the following eleven improvements to help deal with some of these issues:

- Institute reasonable and effective SEC oversight of proxy advisory firms.

    - Proxy advisory firms have become so influential over public companies that they have in essence become the standard setters for corporate governance. Two advisory firms effectively control the market: Institutional Shareholder Services ("ISS") and Glass Lewis. According to the Report, these firms operate with significant conflicts of interest and lack transparency, discouraging small and midsized companies from tapping into the public markets. Legislation introduced in December 2017 would require proxy advisory firms to register with the SEC and to (1) disclose and manage their conflicts of interest, (2) provide issuers with reasonable time to respond to errors or flaws in advisory voting recommendations, and (3) demonstrate that they have the proper expertise to make accurate and objective recommendations. The Report endorses the passage of this or similar legislation, and at a minimum, recommends the SEC's withdrawal of the *Egan-Jones Proxy Services* (avail. May 27, 2004) and *Institutional Shareholder Services, Inc.* (avail. Sept. 15, 2004) no-action letters that minimize scrutiny of proxy advisory firms with respect to conflicts of interest.

- Reform shareholder proposal "resubmission thresholds" under Rule 14a-8 of the Securities Exchange Act of 1934 (the "Exchange Act") to facilitate more meaningful shareholder engagement with management.

    - Rule 14a-8 allows shareholders who own a relatively small amount of company shares to include qualifying proposals in a company's proxy materials. Under current law, Rule 14-8a(i)(12) (the "Resubmission Rule") allows companies to exclude certain shareholder proposals that were voted on in recent years. Specifically, a company may exclude a resubmitted proposal if in the last five years the proposal:

        - was voted on once and received less than 3% of votes cast;

        - was voted on twice and received less than 6% of votes cast the last time it was voted on; or

        - was voted on three or more times and received less than 10% of votes cast the last time it was voted on.

    The Report asserts that the proxy process is currently subject to abuse by a "minority of special interests that use it to advance idiosyncratic agendas." The Report argues that raising these resubmission thresholds, as the SEC proposed in 1997 (6%, 15%, and 30%), is a "good starting point" to modernize the SEC's shareholder proposal system.

The Report also notes that the SEC should withdraw Staff Legal Bulletin 14H (Oct. 22, 2015), which effectively declawed Rule 14a-8(i)(9) that allowed companies to exclude certain shareholder proposals that directly conflict with a management proposal.

- Simplify quarterly reporting requirements.
  - Due to the increased size and complexity of annual (Form 10-K) and quarterly (Form 10-Q) reports, compliance has become increasingly costly and more difficult, especially for smaller companies. The Report recommends granting EGCs the option of issuing a press release that includes quarterly earnings results in lieu of a full Form 10-Q. This approach would simplify the quarterly reporting process for EGCs and reduce the burdens related to financial quarterly reporting, while at the same time still providing investors with necessary material information.
- The "materiality" standard for corporate disclosure should be maintained and certain disclosure requirements should be scaled for EGCs.
  - The Report suggests that the SEC should maintain the longstanding "materiality" standard with respect to corporate disclosures. The Report points to the conflict minerals and pay ratio rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") as examples of disclosure requirements that veer the application of securities laws away from their original mission to provide material information to investors.

    The Report also recommends that policymakers continue to scale down disclosure requirements for EGCs. For example, the Report proposes exempting EGCs from conflict minerals, mine safety, and resources extraction disclosures implemented under the Dodd-Frank Act.
- Allow purchases of EGC shares to be qualifying investments for purposes of Registered Investment Adviser ("RIA") exemption determinations.
  - Under the Dodd-Frank Act, venture capital funds were meant to be exempt from the certain costs and requirements to become an RIA. However, the definition of "venture capital fund" under the Investment Advisers Act is viewed by the Report as narrow, which limits the ability of these funds to invest in EGCs. The Report argues that shares of EGCs should be considered qualifying investments, which would potentially expand investment in EGCs.
- Allow issuers of all sizes to be eligible to use Forms S-3 and F-3 for shelf registration.
  - Many EGCs and small issuers are precluded from using the simplified registration statement Forms S-3 and F-3, which allows faster and cheaper access to public capital markets. The Report, along with the SEC's Annual Government-Business Forum on Small Business Capital Formation, recommends that all issuers be allowed to use Forms S-3 and F-3.[6] In addition, the Report suggests eliminating the "baby-shelf" rules applicable to companies with a public float of less than $75 million, which limit the amount of capital a small-market cap company can raise using a shelf registration statement.

- Address unlawful activity related to short sales.
  - There are currently no disclosure requirements applicable to investors who take short positions in publicly registered stock. Although short selling can have positive effects on the overall market, the Report argues that such transactions can also lead to abusive activity that unduly harms investors or the reputation of a company. The Report recommends that the SEC continue to take action against market manipulators who engage in unlawful activity that harms the market and ensure that there is sufficient public information with respect to potential market manipulation.
- Allow prospective underwriters to make offers of well-known seasoned issuer securities in advance of filing a registration statement.
  - Since 2005, "well-known seasoned issuers" (or "WKSIs") have been permitted to engage in oral or written communications in accordance with Securities Act Rule 163 in advance of filing a registration statement without violating "gun jumping" rules. The SEC proposed an amendment in 2009 that would permit underwriters or dealers to engage in communications "by or on behalf of" WKSIs under similar circumstances, which would allow WKSIs to better gauge investor interest and market conditions prior to an offering. The Report argues that this amendment should be enacted.
- Make eXtensible Business Reporting Language ("XBRL") compliance optional for EGCs, smaller reporting companies ("SRCs"), and non-accelerated filers.
  - Public companies are required to provide financial statements in XBRL, which imposes significant costs on EGCs and SRCs, and in the view of the Report, minimal benefit to investors. Accordingly, the Report recommends exempting EGCs, SRCs, and non-accelerated filers from XBRL reporting requirements.
- Increase the diversified funds limit for mutual funds' position in companies from current 10% of voting shares to 15%.
  - Due to the increased size of mutual funds, the diversified fund thresholds have limited mutual funds' ability to take meaningful positions in small-cap companies. The Report argues that moving the threshold up from 10% to 15% would make investments in EGCs and other small-cap companies more attractive to mutual funds.
- Allow disclosure of selling stockholders to be done on a group basis.
  - The Report recommends that disclosure of selling stockholders in registration statements should be permitted on a group or aggregate basis if each selling stockholder is (1) not a director or named executive officer of the registrant, and (2) holds less than 1% of outstanding shares.

4. Financial Reporting

- The SEC should consider aligning the SRC definition with the definition of a non-accelerated filer and institute a revenue-only test for pre- or low- revenue companies that may be highly valued.
  - In 2016, the SEC proposed increasing the public float cap for SRCs from $75 million to $250 million, but did not do so with respect to non-accelerated filers that are subject to the same limit. In the Report's view, raising this cap for SRCs would help promote capital formation and reduce compliance costs for small companies, including scaled disclosure obligations under Regulation S-K for SRCs. In addition, consideration should be given to whether the exemption available to non-accelerated filers from the requirement for auditor attestation over internal controls should also be extended to SRCs. In particular, the Report points out that many companies may still choose to comply with auditor attestation requirements, noting that shareholders could also encourage issuers to maintain internal control systems similar to those called for by Sarbanes-Oxley Section 404(b).

    In addition, the 2016 SRC proposal introduced an alternative "revenue only" test for companies to qualify as an SRC if the company had less than $100 million in revenue, regardless of its public float. The Report proposes that a revenue-only test should be considered as an alternative standard.

- Modernize the Public Company Accounting Oversight Board ("PCAOB") inspection process related to internal control over financial reporting ("ICFR").
  - In 2007, the SEC issued Commission Guidance Regarding Management's Report on Internal Controls over Financial Reporting under Section 13(a) or 15(d) of the Exchange Act (the "2007 Guidance"). The 2007 Guidance was meant to allow companies to prioritize and focus on "what matters most" in assessing ICFR, principally those material issues that pose the greatest risk of material misstatements. However, companies have continued to experience unintended ICFR-related burdens due to audit processes and PCAOB inspections. The 2007 Guidance has not been effective due to changing interpretations of PCAOB standards for attestations during the inspection process. Accordingly, the Report proposes that the 2007 Guidance should be updated to ensure that it is working as originally intended. The Group also suggests that the PCAOB should consider an ICFR task force to address issues companies face as a result of the PCAOB inspection process and its consequences for audit firms and auditors. Pre- and post-implementation reviews by the PCAOB would improve audit standard setting, prevent harmful impacts, and address the unintended consequences that result from implementation of new PCAOB auditing standards.

5. Tailoring Equity Market Structure for Small Public Companies

While the overall U.S. equity markets have become more efficient due to venue competition and increased liquidity, some of these benefits have failed to reach small and mid-size stocks. The Report makes two recommendations to address market structure challenges faced by these issuers:

- Examine tick sizes for EGCs and small capitalization stocks.

  - The Report argues that the SEC should examine the appropriate tick size, which is the minimum price movement of a trading instrument, for EGCs and small capitalization stocks. The Report notes that while stocks trading in penny increments may be an appropriate trading increment for large capitalization stocks, it may not be the best option for EGCs. This is because narrower spreads resulting from penny increments may disincentivize market makers from trading in EGCs and small capitalization stocks. Instead, individual exchanges should have the flexibility to develop tick sizes that are tailored for a limited number of stocks with distressed liquidity.[7]

- Allow EGCs or small issuers with distressed liquidity the choice to opt out of unlisted trading privileges.

  - The Report recommends that a limited number of SRCs with distressed liquidity be able to opt out of unlisted trading privileges. This would allow these less frequently traded stocks to focus their trading on fewer exchanges, thus enabling buyers and sellers to more easily find each other, providing more liquidity in these stocks. This would also enable these companies to reduce fragmentation in trading, and simplify market making for these stocks.

Conclusion

Since at least 2012, the SEC and Congress have proposed various reforms[8] aimed at improving the attractiveness and competitiveness of the U.S. public capital markets. In the last year, consistent with Chairman Clayton's core principles,[9] the SEC has taken steps to further expand the benefits of the JOBS Act and the FAST Act to a broader range of companies, such as allowing non-EGCs to make confidential submissions of initial registration statements, permitting all companies to confidentially submit registration statements in connection with offerings within one year of an IPO and granting more waivers of financial statement requirements. In addition, there have been a number of legislative proposals intended to further expand the benefits of the JOBS Act and the FAST Act. The Report is consistent with these themes. Congress and the SEC must now consider comprehensive reform in this vein and also consider how a complex system of regulations could be further simplified. Ultimately, a company's decision whether to go public is driven primarily by business rationales, including valuation, liquidity and investor considerations. However, reducing the burdens of becoming and staying a public company without compromising investor protection will benefit both companies and investors, help ensure that the U.S. public capital markets remain attractive and competitive in the face of global competition, and provide more diverse investment opportunities for all investors.

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[1] SIFMA, *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public*, available at https://www.sifma.org/resources/submissions/expanding-the-on-ramp-recommendations-to-help-more-companies-go-and-stay-public (last visited April 27, 2018). Other organizations joining SIFMA in the Report included, among others, the U.S. Chamber of Commerce, the National Venture Capital Association, Biotechnology Innovation Organization (Bio), Technet and Nasdaq.

[2] *Id*.

[3] Under the JOBS Act, EGCs are defined as companies with less than $1.07 billion of annual revenue.

[4] For a more complete discussion on the transition from EGC status, see our Alert from March 12, 2014, which is available at the following link: https://www.gibsondunn.com/emerging-from-egc-status-transition-periods-for-former-egc-issuers-to-comply-with-reporting-and-corporate-governance-requirements/

[5] For a more complete discussion of the interaction between the JOBS Act and the Global Research Settlement, see our alert from October 11, 2012, which is available at the following link: https://www.gibsondunn.com/jobs-act-finra-proposes-rule-changes-relating-to-research-analysts-and-underwriters/

[6] *See generally* SEC Government-Business Forum on Small Capital Business Formation, which is available at the following link: https://www.sec.gov/files/gbfor36.pdf

[7] For additional information, see the SEC's investor alert titled "Investor Alert: Tick Size Pilot Program – What Investors Need to Know" which is available at the following link: https://www.sec.gov/oiea/investor-alerts-bulletins/ia_ticksize.html

[8] For more information, see our post from October 13, 2017 titled "SEC Proposes Amendments to Securities Regulations to Modernize and Simplify Disclosure," which is available at the following link: https://www.gibsondunn.com/sec-proposes-amendments-to-securities-regulations-to-modernize-and-simplify-disclosure/

[9] *See, e.g.*, "SEC to Tailor Disclosure Regime Under New Chair Clayton" (July 12, 2017), which is available at the following link: https://www.bna.com/sec-tailor-disclosure-n73014461648/

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's Capital Markets or Securities Regulation and Corporate Governance practice groups, or the authors:

Glenn R. Pollner - New York (+1 212-351-2333, gpollner@gibsondunn.com)
Hillary H. Holmes - Houston (+1 346-718-6602, hholmes@gibsondunn.com)
Jessica Annis - San Francisco (+1 415-393-8234, jannis@gibsondunn.com)
Nicolas H.R. Dumont - New York (+1 212-351-3837, ndumont@gibsondunn.com)
Sean Sullivan - San Francisco (+1 415–393–8275, ssullivan@gibsondunn.com)
Victor Twu - Orange County, CA (+1 949-451-3870, vtwu@gibsondunn.com)

Please also feel free to contact any of the following practice leaders:

Capital Markets Group:
Stewart L. McDowell - San Francisco (+1 415-393-8322, smcdowell@gibsondunn.com)
Peter W. Wardle - Los Angeles (+1 213-229-7242, pwardle@gibsondunn.com)
Andrew L. Fabens - New York (+1 212-351-4034, afabens@gibsondunn.com)
Hillary H. Holmes - Houston (+1 346-718-6602, hholmes@gibsondunn.com)

Securities Regulation and Corporate Governance Group:
Elizabeth Ising - Washington, D.C. (+1 202-955-8287, eising@gibsondunn.com)
James J. Moloney - Orange County, CA (+1 949-451-4343, jmoloney@gibsondunn.com)
Lori Zyskowski - New York (+1 212-351-2309, lzyskowski@gibsondunn.com)