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TOP 10

PRACTICE TIPS BY EXPERTS: EMERGING GROWTH COMPANIES

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The passage of the Jumpstart Our Business Startups Act (112 P.L. 106, 126 Stat. 306 (JOBS Act) in April 2012 introduced a new classification of companies to the U.S. securities laws. One of the JOBS Act's goals for this new class, known as emerging growth companies (EGCs), was to promote more public companies in the United States by providing EGCs benefits and exemptions during, and potentially for up to five years following, a company's initial public offering (IPO). In December 2015, the Fixing America's Surface Transportation Act (114 P.L. 94) (FAST Act) included several amendments to the federal securities laws that sought to further this goal. Below are 10 practice points that can help you determine whether a company qualifies as an EGC and the benefits and exemptions available if it does.

1. UNDERSTAND THAT EGCS COME IN ALL SHAPES AND SIZES.

According to Proskauer's proprietary 2017 IPO Study examining data from over 375 U.S.-listed IPOs with a minimum initial base deal size of $50 million (2017 IPO Study), approximately 81% of IPOs from 2013 through 2016 were by EGCs. EGC status is not limited to technology or other start-up companies. Companies that are well known to the public and that have achieved billion-dollar valuations can also qualify as EGCs. According to the 2017 IPO Study, from 2013 through 2016, the average market capitalization of an EGC at the pricing of its IPO was $924 million. In March 2017, Snap Inc. completed its IPO as an EGC with a market capitalization of $33 billion. In addition, EGC status is not limited to U.S.-based or U.S.-organized companies. Foreign companies, including those with minimal operations in the United States, can qualify as EGCs.

2. TEST EGC QUALIFICATION AS SOON AS THE COMPANY CONTEMPLATES AN IPO.

Qualifying as an EGC will affect the timing and process of the company's IPO, as well as preparation of the IPO registration statement. Accordingly, one of the first things a company contemplating an IPO should analyze is whether it qualifies as an EGC. A pre-IPO company will qualify as an EGC if (i) it had less than $1.07 billion of gross revenue during its most recently completed fiscal year and (ii) it has issued no more than $1 billion in non-convertible debt during the prior three-year period. Because a company's status as an EGC can change if the company crosses into a new fiscal year or issues additional non-convertible debt, the company should continuously monitor its status throughout the IPO process.

3. CONSIDER TESTING-THE-WATERS TO DETERMINE WHETHER THERE IS INTEREST IN THE IPO PRIOR TO COMMITTING TO THE PROCESS.

Companies that do not qualify as EGCs may generally communicate with potential investors in connection with the IPO process only after they publicly file their IPO registration statement. However, one of the key benefits of being an EGC is the ability to communicate with certain types of institutional investors prior to publicly filing the registration statement (testing-the-waters). By being able to test-the-waters with qualified institutional buyers (QIBs) and institutional accredited investors, an EGC can assess whether there is investor interest in its IPO prior to committing the time and resources to prepare a registration statement and begin the IPO process. EGCs can also use testing-the-waters communications to refine their IPO messaging and marketing focus. Furthermore, an EGC can continue to test-the-waters following the public filing of its registration statement and even in connection with public offerings after the IPO. According to the 2017 IPO Study, EGCs in the biopharm/biotech and technology, media, and telecommunications sectors reported the most engagement in testing-the-waters communications for their IPOs between 2013 and 2016. EGCs should consider the following when testing-the-waters:

- During the SEC staff's review of the IPO registration statement, it routinely requests copies of any testing-the-waters communications that the company or underwriters have used. The SEC staff will likely review the communications to evaluate whether they contain any material information that is not included in the registration statement.
- Any information contained in testing-the-waters materials should be carefully vetted and consistent with the information ultimately included in the registration statement. In this regard, underwriters for the IPO will generally require the company to represent that the testing-the-waters communications are accurate in all material respects and indemnify the underwriters against any claim relating to materially untrue statements or omissions in the testing-the-waters communications.
- Testing-the-waters materials should include a statement regarding the confidentiality of the materials and the fact that the company is providing the materials in reliance on an exemption available to EGCs.

4. UNDERSTAND THE EXEMPTIONS FOR FINANCIAL INFORMATION.

An EGC is permitted to include less financial information in its IPO registration statement, as summarized below:

- Audited financial statements and management's discussion and analysis (MD&A) are required for only the two most recently completed fiscal years as compared to the three most recently completed fiscal years for non-EGCs. According to the 2017 IPO Study, 39% of EGCs in 2013 included only two years of financial statements compared to 75% in 2016. The reason for this dramatic increase may be that investors are becoming accustomed to only two years of audited financial statements from EGCs and are not demanding the full three years.
- Selected financial data is not required for any period prior to the earliest audited period included in the registration statement. According to the 2017 IPO Study, 60% of EGCs in 2013 included only the minimum period of selected financial data compared to 82% in 2016. Non-EGCs are generally required to include five years of selected financial data in an IPO registration statement. EGCs might elect to include more than the minimum selected financial data because the data and multi-year trends may be material or helpful to investors

5. DECIDE WHETHER TO OPT-IN OR OPT-OUT OF EXTENDED TRANSITION PERIODS FOR NEW OR REVISED ACCOUNTING STANDARDS.

One benefit available to an EGC is that it may take advantage of the extended transition period for new or revised accounting standards that is available to private companies. An EGC must elect whether to take advantage of this benefit at the time it files its IPO registration statement. If the EGC opts-out of the benefit, then this election is irrevocable. However, if the EGC opts-in to the benefit, then it can later change its mind and opt-out of the benefit (at which point its decision to opt-out becomes irrevocable). If an EGC has opted-out of the benefit, then its election to not take advantage of the extended transition periods applies to all new or revised accounting standards. In other words, the EGC cannot take advantage of the extended transition periods for some new standards but not others.

6. FAMILIARIZE YOURSELF WITH THE SCALED EXECUTIVE COMPENSATION DISCLOSURE REQUIREMENTS.

Another disclosure benefit for EGCs is reduced executive compensation disclosure. An EGC can provide executive compensation information on the same basis as a smaller reporting company (SRC). This means that compensation information is generally required only for the EGC's chief executive officer (CEO) and the two mostly highly paid executive officers other than its CEO. Furthermore, an EGC is not required to include a compensation discussion and analysis (CD&A) and may provide only a summary compensation table and an outstanding equity awards at fiscal year-end table.

7. CONTINUE TO ASSESS EGC QUALIFICATION FOLLOWING THE IPO.

The benefits of being an EGC extend beyond the company's IPO. Accordingly, a company that qualified as an EGC for its IPO should continue to assess its qualification to ensure that it can take advantage of these additional benefits. Following its IPO, a company will remain an EGC until the earliest of the following events:

- The last day of the fiscal year during which the company had gross revenues of $1.07 billion or more
- The last day of the fiscal year following the fifth anniversary of the IPO
- The date on which the company has issued, during its previous three-year period, more than $1 billion in non-convertible debt
- The date on which the company is deemed a large accelerated filer, which generally is the last day of the fiscal year (other than the year of the IPO) for which the company had at least $700 million of public float as of the end of the second fiscal quarter of that year

8. CONSIDER TAKING ADVANTAGE OF EGC BENEFITS FOLLOWING THE IPO.

Similar to its IPO registration statement, an EGC may include less disclosure in its Annual Report on Form 10-K and proxy statement in several areas:

- Auditor attestation on internal control over financial reporting is not required.
- Selected financial data is not required for any period prior to the earliest audited period included in the IPO registration statement.
- The EGC can provide reduced executive compensation disclosure, including no CD&A or CEO pay ratio disclosure.
- Say-on-pay, frequency of say-on-pay, and golden parachute advisory voting are not required.

9. CONSIDER WHETHER THE COMPANY QUALIFIES AS A SMALLER REPORTING COMPANY, IF IT NO LONGER QUALIFIES AS AN EGC.

If a company loses its status as an EGC following its IPO, it should analyze whether it would qualify as an SRC prior to transitioning to the disclosure required for a regular company. Generally, a company qualifies as an SRC if its public float as of the end of its most recent second fiscal quarter is less than $75 million. SRCs have some of the same exemptions from disclosure as EGCs. Namely, an SRC is not required to provide an auditor attestation on internal control over financial reporting and it can provide reduced executive compensation disclosure, including no CD&A or CEO pay ratio. Furthermore, an SRC is not required to provide any selected financial data. However, an SRC is required to hold say-on-pay, frequency of say-on-pay, and golden parachute advisory votes.

10. START PLANNING EARLY FOR A COMPANY'S POTENTIAL LOSS OF EGC STATUS.

The events that cause a company to lose its status as an EGC are well defined. Once a company is no longer an EGC, and assuming it is also not an SRC, it will have many additional compliance requirements. If a company may potentially lose its status as an EGC, then it should prepare early for these additional compliance requirements. For example, a company that may exceed $1.07 billion in annual gross revenue should not wait until the end of the fiscal year, after confirming that it has in fact exceeded that amount, to discuss with its auditor the potential need for an attestation on the company's internal control over financial reporting, as such attestation requires time to prepare.

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