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Underwriters of D & O and Professional Liability Insurance

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In this issue … we look at the JOBS Act after a year in force.

INTRODUCTION

On April 5, 2012 the federal "Jumpstart Our Business Startups (JOBS) Act" became law. As the first anniversary approaches, we look at the JOBS Act, its intent, its implementation, and its impact so far.

The imperative behind the JOBS act was concern over the drastic reduction in the number of publicly listed companies on the U.S. equity exchanges, and that the number of initial public offerings (IPOs) coming to the capital markets was not enough to offset that reduction. Inherent in that concern was the belief that employment opportunities were being reduced due to the lack of new entrants to the public market arena.

The shrinkage in the number of public companies, which began around 1997, was the topic of an earlier newsletter in January 2012, which cited an estimate of up to 22 million jobs that may have been lost between 1997 and 2008 due to the reduction. Statistics such as those are likely to have helped trigger the development of the JOBS Act, and help explain why the measure received widespread bi-partisan support in Congress.

We will take a broad look at what the JOBS Act contains, how extensively its provisions have been exercised over the past twelve months or so, and discuss in general its effectiveness and the larger issue of encouraging "emerging growth companies."

THE JOBS ACT

Compared to the Dodd-Frank legislative leviathan, the seven titles of the JOBS Act are contained in around forty pages. Of those seven titles, Title I and Title II address the key provisions referred to by President Obama in his speech when he signed the measure:

Title I: Reopening American Capital Markets to Emerging Growth Companies
This Title, more colloquially known as the "IPO On-Ramp" provision, attempts to make the road to an IPO less tortuous and costly by lightening some of the regulatory and compliance burdens.

After defining what is meant by an "emerging growth company (EGC)," and stipulating when that status no longer applies (in any event for no more than five years after listing), the Act sets out benefits, which include:

1. A new flexibility for EGCs to informally "test the waters" ahead of a possible IPO by contacting qualified institutional buyers of securities, or institutions that are accredited investors, to gauge their interest level in a "contemplated securities offering."

2. A confidential review process whereby the EGC may submit a draft IPO registration statement to the Securities and Exchange Commission (SEC) up to 21 days before the EGC embarks on its "road show" to solicit the interest and commitment of large investors.

3. Only two years of audited financial statements are required to be included in the SEC filing, rather than the previous requirement of three years. The two-year requirement was already available to "smaller reporting companies," but that relief is now extended to any EGC.

4. As long as a company qualifies as an EGC, it will not be subject to the shareholder "say-on-pay," "say-on-frequency," or "say-on-golden-parachute" provisions required under Dodd-Frank.

5. Various internal controls, audit and accounting requirements are relaxed. These include an exemption for EGCs from the requirements of Sarbanes-Oxley Section 404 (b) for an auditor attestation of internal controls.

This Title was effective immediately upon the enactment of the JOBS Act.

Title III: Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure
Better known by its acronym ("CROWDFUND") this Title is intended to facilitate investment in EGCs by individuals outside the usual range of professional investors. It provides for the establishment of on-line platforms to enable these smaller investors to participate in capital raising by an EGC.

This Title is not in place; it awaits the creation of Rules by the SEC that will prescribe how such platforms are to operate. The Rulemaking required by this and other Titles of the JOBS Act is way behind the JOBS Act schedule —a point forcefully made in a letter from the Chairman of the House of Representatives' Committee on Oversight and Government Reform to the Chairman of the SEC.

UTILIZATION OF TITLE I BY EGCS SINCE APRIL 2012

Issuers qualifying as emerging growth companies have clearly been availing themselves of at least some of benefits granted under the IPO On-Ramp provision. According to a detailed review of the first nine months of the JOBS Act by the law firm of Skadden, Arps, Slate, Meagher & Flom LLP, "53 EGCs completed IPOs with gross proceeds of more than $75 million." The review's findings include:

- The ability to make confidential draft registration statements to the SEC was widely utilized, with almost seventy percent making one or more confidential submissions.

- Almost all EGCs that had a choice between offering two or three years of audited financial statements opted to provide three years: 88 percent, while 65 percent elected to provide five years of selected financial data.

- The extent of EGCs "testing the waters" by advance communication with large investors was harder to determine; Skadden believes there has been "mixed acceptance" of this provision, largely deal-specific.

- The ability to offer only limited disclosure regarding executive compensation has been widely exercised: "Virtually all EGCs that commenced their IPOs after April 15, 2012 have provided scaled [limited] executive compensation disclosure."

- The exemption from Sarbanes-Oxley 404(b) to delay providing auditor attestation has been strongly taken up, with "virtually all EGCs" disclosing that they intend to, or may, take advantage of this provision.

- The extended transition period for compliance with new accounting standards has not been widely taken up; the report suggests a qualified figure of twenty-percent acceptance.

It therefore appears that while utilization of the available benefits under Title I is inconsistent, certain aspects have been seized upon by EGCs, and that almost every IPO that qualifies as an EGC is now making use of at least one element of the On-Ramp provisions: anecdotal evidence from the D&O market backs this up.

COMMENT

Widespread use of the JOBS Act benefits is not the same as a successful verdict on the effectiveness of JOBS in increasing the number of companies coming to the capital markets.

How many of the IPOS launched since April 2012 would have launched anyway, regardless of JOBS, is almost impossible to determine. The actual IPO data do not reveal a significant jump in frequency since JOBS inception; "too soon to tell" is an easy conclusion and one that recurs among commentators. That is surely correct, but will the true impact of the JOBS Act ever really be known with any certainty?

For a company pondering an IPO launch there is clearly a myriad of economic and business factors to be considered, generally more critical than regulatory and compliance concerns. Not least of these factors is the prevailing state of the equity markets, and since April 2012 the NASDAQ Composite index has risen from around 2,726 to around 3,252, or nearly twenty percent. Such an upbeat market would generally serve to encourage a company to proceed with an IPO.

Beyond the JOBS Act, other possible initiatives to encourage IPOs are being discussed. These include changes to a stock's "tick size" that will result in stated incremental increases and decreases in its stock price. Some observers feel this would ultimately benefit issuers by creating more liquidity in the post-IPO secondary market. This notion is under review by the SEC's Advisory Committee on Small and Emerging Companies, along with the idea of creating a new exchange solely for the trading of emerging companies.

But notwithstanding the efforts of the JOBS Act and other initiatives, perhaps there is a greater issue, and one put forward by some commentators, that the IPO as the natural path for EGCs to follow might be yesterday's news, and that the JOBS Act is an attempted solution to yesterday's problem. Instead, the sale of an emerging company to a private equity group or to a larger established company in the same field might be an easier and more attractive proposition.

The story of Groupon, Inc., while in some respects a special case, nonetheless is illustrative. In late 2010, Google reportedly offered the owners of Groupon around $6 billion dollars to buy the company; this offer was rejected. Groupon launched an IPO in November 2011. Some 16 months later, following a succession of problems including the departure of its CEO, the Groupon market capitalization is around $3.48 billion, considerably less than the $6 billion offered by Google.

THE EFFECT OF THE JOBS ACT ON D&O INSURANCE

Implementation of the JOBS Act creates an uncomfortable dichotomy within the SEC. Charged with protecting the nation's investors, the SEC has been asked to oversee the JOBS Act, which almost by definition is designed to loosen some regulatory restraints that were in place for the benefit of investors. The availability to EGC issuers of reduced disclosures will almost certainly translate into more opacity —something that Sarbanes-Oxley, Dodd-Frank, and the SEC have tried to combat. Sally Greenberg of the National Consumer League said of the JOBS Act: "When you open the floodgates, reduce regulations, and make it easier for even legitimate companies to go public, it's also an invitation for bad actors."

The federal Securities Exchange Acts of 1933 and 1934 (and violations thereof) are central to Directors & Officers liability insurance, and the JOBS Act systematically amends these statutes. It is therefore hard to imagine that the JOBS Act will have no impact on D&O insurance, but it is unlikely that any effect will be revealed until much more time has passed. ❖

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