



What's Driving the Strong U.S. IPO Market? A Look at the JOBS Act at Its Second Anniversary In Light of the Increased IPO Volume

The Jumpstart Our Business Startups Act (the "JOBS Act"), designed to stimulate IPO activity in the U.S. is celebrating its second anniversary this month at a time when U.S. IPO activity is at a high since 2000. While adoption of several of the JOBS Act accommodations are increasing, confidential submissions of IPO registration statements has had the most significant impact on how IPOs are being conducted, and perhaps even on the number of IPOs.

2014 U.S. IPO Market Off to a Strong Start

The U.S. IPO market was off to an even stronger start in 2014 than it was in 2013. The first quarter of 2014 showed more activity than any other first quarter since 2000 as 64 companies raised \$10.6 billion and 103 new IPOs were filed, according to data from Renaissance Capital.¹ That is more than double the number of IPOs in the first quarter of 2013.² 2013 was the strongest year in U.S. IPO activity since 2000, representing a broad-based resurgence led by the technology and biotechnology sectors both in terms of number of IPOs and capital raised as 222 companies went public in 2013, raising \$54.9 billion and generating an average return of approximately 41%, outperforming the 2013 benchmark indices.³

The number of IPOs in the first quarter of 2014 led to a 39% increase in proceeds raised over the first quarter in 2013 as investors sought out growth companies in a continued low interest rate environment. Almost half (30) of all IPOs in the first quarter were health care companies, with an overweight of biotechnology companies (26). The technology sector also played a large role with 14 companies going public, most of which focused on enterprise software, though a late-quarter sell off among growth stocks impacted the IPO space as well. With 40 venture capital-backed IPOs and 16 private equity-backed IPOs, sponsors continue to play an important part in the U.S. IPO market. The average IPO return was approximately 25%, which is higher than last year's first quarter and outperforms the benchmark indices for the quarter.⁴ While there is some caution in the market regarding overly optimistic valuations, causing a sell-off in growth stocks that has carried on into April, with 122 companies in the IPO pipeline, including 103 new filings in the first quarter worth an estimated total of \$32.3 billion in proceeds, the outlook suggests that 2014 could be even more active than 2013.⁵

¹ Renaissance Capital, US IPO Market, 1Q 2014 Quarterly Review, March 31, 2014.

² Id.

³ Renaissance Capital, US IPO Market, 2013 Annual Review, January 2, 2014. All historical IPO performance data herein is derived from the 1Q 2014 Quarterly Review and 2013 Annual Review, which includes IPOs with a market capitalization of at least \$50 million and excludes closed-end funds and SPACs.

⁴ Renaissance Capital, US IPO Market, 1Q 2014 Quarterly Review, March 31, 2014.

⁵ Id.

What's Driving the Market?

Two years have passed since the JOBS Act was signed into law on April 5, 2012. We will take a look at the provisions related to IPOs that have been effective since enactment and that seek to encourage companies with less than \$1 billion in annual revenues, or emerging growth companies (“EGCs”), to pursue IPOs.⁶

Broad Economic Factors Restarted the U.S. IPO Market

While most observers agree that, rather than the JOBS Act, broad economic factors – including low interest rates, a rising stock market, less overall market volatility and a revived confidence in the IPO market by growth companies and venture capital and private equity sponsors – drove the increased volume of IPO activity in 2013 and continue to do so in the first quarter of 2014, the JOBS Act, and particularly confidential submissions of IPO registration statements, has impacted IPO practices significantly. The ability to make confidential submissions to the SEC may even impact the number of IPOs for the reasons discussed below.

The JOBS Act Impact – EGCs Are Dominating the U.S. IPO Market

The JOBS Act reformed the IPO process for EGCs by implementing a number of substantive and procedural reforms, created the new category of EGC issuers and provided certain benefits to EGCs:

- IPO “on-ramp” regulations intended to encourage IPOs by phasing in compliance measures over time
- Confidential submissions of IPO registration statements
- Scaled or exempt disclosure requirements
- No restrictions on test-the-waters communications with qualified institutional buyers (QIBs) and institutional accredited investors
- Fewer restrictions on research around the time of an IPO

At its second anniversary, IPO practices are changing significantly as a result of the JOBS Act. The IPO market in 2013 was dominated by EGCs, representing approximately 81% of all IPOs in 2013. This trend is increasing in the first quarter of 2014, where approximately 88% of all IPOs were conducted by EGCs. Accordingly, the creation of the EGC issuer category and the benefits afforded to them has been widely adopted by companies that qualify. EGCs come from many industry sectors, with biotechnology companies representing the largest group of EGC IPO issuers both in the first quarter of 2014 and 2013. The allocation in the first quarter was: health care (biotechnology overweight) 52%, technology 21%, energy 9%, real estate 5%, financial services 5% and other industries combined 7%. With the expectation that the 2014 IPO market will broaden to other industries, including financial services and real estate,⁷ the EGC industry allocations will evolve.

Confidential Submission of IPO Registration Statements Are Becoming Universal

An EGC is permitted to submit a draft IPO registration statement for confidential review by the Securities and Exchange Commission (the “SEC”), provided the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the EGC commences a road show. In 2013, approximately 81% of companies filing IPOs chose to file as EGCs, and approximately 87% of these EGCs confidentially submitted their

⁶ An EGC is a company, including a foreign private issuer, with total annual gross revenues of less than \$1 billion during its most recently completed fiscal year.

⁷ Renaissance Capital, US IPO Market, 1Q 2014 Quarterly Review, March 31, 2014.

IPO registration statement to the SEC. In the first quarter of 2014, 88% of companies filing IPOs chose to file as EGCs and 93% of these EGCs made confidential submissions to the SEC.⁸

As such, at its second anniversary, confidential submissions under the JOBS Act have become nearly universal with 9 out of 10 EGCs taking advantage of this approach. This makes confidential submissions the most significant part of the JOBS Act to date.

Why the Significant Impact of Confidential Submissions?

There are few, if any, disadvantages to the confidential submission process. It permits an EGC to commence the SEC review process without publicly disclosing sensitive strategic, proprietary and financial information, and the EGC can proceed without competitors and the market becoming aware of the proposed IPO. An EGC therefore has greater flexibility to control the timing of an IPO. If faced with adverse market conditions or weak investor demand (for example in response to test-the-waters communications or regulatory concerns), an EGC may withdraw its confidential submission and terminate the IPO process without ever making a public filing. As the data illustrates, this part of the JOBS Act has proved attractive to almost all EGCs, as it removes a potential disincentive to commencing an IPO, and permits the immediate pursuit of a private placement or M&A transaction without the negativity surrounding a failed or withdrawn IPO.

An EGC may decide to pursue a dual-track process, whereby it will decide to undertake an IPO and also consider M&A alternatives. For an EGC that chooses the confidential submission approach, the confidential submission will not create heightened interest on the part of potential acquirers in acquiring the company, whereas publicly available IPO filings may have that effect. An EGC may publicly announce the confidential submission of the registration statement, provided the press release complies with limitations imposed by Rule 135 to avoid gun-jumping issues. And some EGCs have chosen to do so. There may be strategic reasons for this type of announcement, particularly if an EGC is engaged in a dual-track process.

The confidential submission approach has impacted the way IPOs are conducted, but may also impact the number of IPOs, as the ability to withdraw an IPO outside the public eye may increase the appetite for initiating an IPO in the first place.

Use of Other EGC Benefits

The extent to which other EGC benefits are being adopted in the IPO market varies, and some practices differ between industry sectors, though generally EGCs increasingly take advantage of the scaled and exempt disclosures under the JOBS Act.

Reduced Financial Statements and Selected Financial Data. An EGC may present two years of audited financial statements in its IPO registration statement, rather than the three years required for a non-EGC, and as few as two, rather than five, years of selected financial data. While practices still vary, an increasing majority of EGCs is taking advantage of the ability to include reduced financial disclosures, a trend predominantly led by biotechnology companies, and to some extent the technology and other sectors.

Scaled Executive Compensation Disclosure. A vast majority of EGCs rely on the rules related to limited executive compensation disclosures, which allow them to omit the detailed compensation discussion and analysis (CD&A), provide information for the top three, rather than the top five, executive officers and omit four of the six executive compensation tables required for non-EGCs.

⁸ Based on review of SEC filings.

Exempt Internal Controls Auditor Attestation. Almost all EGCs indicate they intend to take advantage of (or reserve the right to do so in the future) the extended phase-in for compliance with the requirements under Section 404(b) of the Sarbanes-Oxley Act to have an auditor attest to the quality of the company's internal controls over financial reporting.

Testing the Waters. The JOBS Act eases restrictions on communications prior to and during the offering process by permitting an EGC, or a person acting on its behalf, to make oral and written offers to QIBs and institutional accredited investors to "test the waters" and gauge their interest in the offering. While practices relating to test-the-waters communications have emerged, they are still evolving and vary depending on the issuer's industry sector, such as the biotechnology sector, where testing the waters seems more prevalent.

Research Coverage. The JOBS Act promotes research coverage of EGCs by relaxing many prohibitions relating to research that were adopted in the aftermath of the U.S. dot-com bubble in the early 2000s. Post JOBS Act, research practices generally remain unchanged, as underwriters generally have not taken advantage yet of the relaxed research coverage rules.

Conclusion

While the restarted U.S. IPO market cannot be attributed principally to the JOBS Act but rather to continued favorable market conditions generating renewed economic confidence and a low interest rate environment, it is difficult to deny that the JOBS Act has significantly impacted the manner in which IPOs are conducted. At its second anniversary, the confidential submission process particularly has been almost universally adopted by EGCs, and may even have increased the number of IPOs by "moving" some EGCs to initiate an IPO with the flexibility of withdrawing it without any public attention.

We expect EGCs to continue to take advantage of the confidential submission process, reduced financial disclosure, scaled compensation disclosure and the exempt internal controls auditor attestation, while we will have to wait and see if market participants will take greater advantage of the testing the waters and research coverage accommodations.

MOFO JUMPSTARTER

For a jump start on the JOBS Act, please visit our MoFoJumpstarter blog: www.mofojumpstarter.com.

Author

Gerd D. Thomsen
San Francisco
(415) 268-6572
gthomsen@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer's* A-List for 10 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us

stronger. This is MoFo. Visit us at www.mofo.com. © 2013 Morrison & Foerster LLP. All rights reserved.

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmks.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.