Emerging Growth Company IPO Filings Initially Embrace JOBS Act's Reduced Executive Compensation Disclosure Requirements

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On April 5, 2012, the President signed into law the "**Jumpstart Our Business Startups Act**" (JOBS Act). The JOBS Act also allows small businesses to harness "crowdfunding," expands "mini-public offerings," and streamlines the process for going public for "emerging growth companies". For a discussion of general provisions in the JOBS Act, please see our April 5, 2012 blog entitled "**President Obama Signs JOBS Act: Landmark Reform for Small and Emerging Growth Companies Now Law**".

Included in the JOBS Act, and which is the subject of this article, are amendments to executive compensation related laws dealing principally with the initial public offering (IPO) process and publicly-held company reporting requirements for a new class of "emerging growth companies" (EGC).

In this regard, we reviewed EGC new IPO public filings with the Securities and Exchange Commission (SEC) for the ten weeks following the enactment of the JOBS Act and provide below our general observations on the executive compensation disclosures in such filings.

The executive compensation related provisions in the JOBS Act were effective upon enactment and are discussed below.

Definition of an "Emerging Growth Company"

Under Section 101 of the JOBS Act, an "emerging growth company" means an issuer, other than an issuer that completed its IPO on or before December 8, 2011, that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. Such an issuer remains as an EGC until the earliest of the:

- last day of its fiscal year during which it had total annual gross revenues of $1 billion or more (subject to inflationary adjustment by the SEC every five years);
- last day of its fiscal year following the 5^{th} anniversary of its IPO;
- date on which it has issued more than $1 billion in non-convertible debt during the previous 3-year period; or
- date on which it is deemed to be a "large accelerated filer" (which requires, among other things, having common equity held by non-affiliates with a market value of $700 million or more).

Significant Reduction in Executive Compensation Disclosure Requirements

Pursuant to Section 102(c) of the JOBS Act, an EGC is permitted to comply with Item 402 of Regulation S-K, which requires extensive quantitative and qualitative disclosure regarding executive compensation, by disclosing only the considerably more limited executive compensation disclosures required of a "smaller reporting company" (SRC). Accordingly, among other things, an EGC:

- does not have to provide a Compensation Discussion and Analysis (CD&A);
- does not have to provide a disclosure of the relationship of compensation policies and practices to risk management;
- only has to provide a Summary Compensation Table (SCT) and an Outstanding Equity Awards at Fiscal Year-End Table with accompanying narrative text and does not have to provide any of the other compensation tables required for non-SRC issuers; and
- can limit its SCT to only its principal executive officer and its two most highly compensated officers (rather than also including the principal financial officer and a third most highly compensated officer) and to two (rather than three) fiscal years of compensation information.

Commentary on Executive Compensation Implications: This significant reduction in the executive compensation disclosure requirements for EGCs provided by the JOBS Act may seem somewhat surprising given the federal government's focus over the past several years on compelling fulsome disclosure of compensation programs and policies and agreements as they relate to the senior executives of publicly traded companies, including providing descriptions on the rationale for the issuer's executive compensation decisions. While SRCs enjoy the benefits of only having to provide scaled back executive compensation disclosures, EGCs may potentially be much larger in size and resources (and with a concomitant greater number of investors) than SRCs. Thus, it remains to be seen whether the marketplace adopts these lessened compensation disclosure standards or will prefer to see disclosures that are otherwise required of non-SRCs.

We separately note that, except for qualifying performance-based compensation, Section 162(m) of the Internal Revenue Code generally limits a public reporting company's tax deduction to $1 million of annual compensation paid to the company's "covered employees" which consist of the company's executive officers (other than the principal financial officer) who are required to be disclosed in the SCT. While Section 162(m) does provide a transitional relief period of up to several years for new IPO companies, when Section 162(m) does become applicable to an EGC, such EGC will presumably have fewer covered employees to address by virtue of the JOBS Act limiting the number of executive officers that must be included in the SCT.

Exemption from Say-on-Pay, Say-on-Golden Parachutes and Other Compensation Related Provisions of the Dodd-Frank Act

As we have previously commented (see for example our blog from **July 26, 2010 "The Regulatory March to Reform Executive Compensation Practices Takes Another Step Forward"**), the **Dodd-Frank Wall Street Reform and Consumer Protection Act** (Dodd-Frank Act) implemented numerous new laws affecting executive compensation and corporate governance at publicly held companies. As a result of the Dodd-Frank Act, the Securities Exchange Act of 1934 (Exchange Act) now requires publicly held companies to provide their shareholders with the ability to render separate non-binding advisory votes to approve: (1) named executive officer compensation (Say-on-Pay), (2) the frequency of Say-on-Pay votes (Say-on-Frequency), and (3) golden parachute arrangements for the company's named executive officers in connection with a merger/acquisition and other similar transactions (Say-on-Golden Parachutes). The Dodd-Frank Act also imposed other new executive compensation related disclosures on publicly held companies.

Pursuant to Section 102(a) of the JOBS Act, an EGC is exempt from complying with the following Dodd-Frank Act requirements (some of which have even yet to be implemented by the SEC):

- the Say-on-Pay, Say-on-Frequency and Say-on-Golden Parachutes for a minimum of three years (and potentially up to six years). Note that by comparison, SRCs are exempt from Say-on-Pay and Say-on-Frequency votes only until January 21, 2013 and are not exempt from the Say-on-Golden Parachutes vote.
- disclosure relating to the relationship between executive compensation and financial performance of the issuer.
- disclosure as to the ratio between the annual total compensation of the CEO and the median of the annual total compensation of all employees of the company.

Commentary on Executive Compensation Implications: The exemption from these Dodd-Frank Act requirements (which were created less than two years ago), and specifically the mandatory Say-on-Pay vote (which itself only commenced in 2011), is also somewhat surprising given the general desire to provide shareholders with a greater voice in their company's executive pay practices. Of course, as with most disclosure requirements, a company may elect to forego the above exemptions and voluntarily comply with some or all of the requirements that apply to non-EGCs. And, the marketplace (or the shareholders of a particular EGC) may induce certain EGCs to provide these additional disclosures even if not technically required.

Confidentially Submit a Draft IPO Registration Statement Prior to Public Filing

Section 106 of the JOBS Act permits an EGC to submit a draft registration statement confidentially to the SEC for nonpublic review and such statement need not become publicly available until 21 days prior to the EGC's first road show. Additionally, **the SEC announced** in April 2012 that a registration fee is not required with a confidential draft registration statement.

Commentary on Executive Compensation Implications: Since disclosure of executive compensation is generally a sensitive topic, and particularly so with respect to a private company that has not publicly made such disclosures until the IPO process, this represents a potentially beneficial reason for issuers to consider initially pursuing this confidential filing route in its IPO process.

SEC Directed to Review Regulation S-K

Section 108 of the JOBS Act directs the SEC to conduct a review of Regulation S-K to (i) comprehensively analyze the current registration requirements of the regulation and (ii) to "determine how such requirements can be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with these requirements for issuers who are emerging growth companies."

The SEC is required to provide its recommendations to Congress no later than 180 days after April 5, 2012.

Commentary on Executive Compensation Implications: It is currently unknown what recommendations will be made by the SEC to make the registration process more efficient and less burdensome for prospective issuers who are EGCs than already provided by the JOBS Act. It will also be interesting to see if the SEC recommends any changes to the executive compensation disclosure rules which were significantly expanded in 2006 and which subsequently have already had further revisions.

Exclusion of Holders of Employee Benefit Plan Securities from the Exchange Act Registration "Held of Record" Definition

Prior to the JOBS Act, Section 12(g) of the Exchange Act and its related rules required a company with more than $10 million in assets and more than 500 holders of record of any class of its equity securities to register under the Exchange Act and begin complying with the extensive disclosure and financial reporting obligations applicable to publicly held companies.

Section 502 of the JOBS Act now excludes securities held by persons who received them pursuant to employee compensation plans from the "held of record" definition. Additionally, Section 501 of the JOBS Act increases the holder threshold to 2,000 holders, provided no more than 500 are unaccredited investors.

<u>Commentary on Executive Compensation Implications</u>: These amendments to Section 12(g) may be significant for larger privately held companies because it means that such private companies with numerous optionees, or awardees of compensatory equity awards other than stock options, can be less concerned with exceeding this threshold and thereby becoming subject to the disclosure and reporting requirements of a public company without having gone public in the traditional sense.

EGC IPO S-1 Filings Since JOBS Act Enactment

We looked at the nine EGC Form S-1 new IPO registration statements that were publicly filed with the SEC during the ten–week period from the JOBS Act enactment through June 18, 2012. We excluded from our survey those Form S-1 registration statements of companies that either (1) did not qualify as an EGC or (2) checked the box on their S-1 that stated that they were an SRC. We note that the S-1 registration statements we reviewed had not yet been declared effective so it is conceivable that their executive compensation disclosures could be modified in future S-1 amendments.

While not a statistically significant sample size and while these filings present only a very preliminary indication of any future trend or what might become custom and practice since the JOBS Act was enacted less than three months prior to our review period, it does initially appear that new EGC filers are generally omitting the CD&A section from their S-1 registration statements and are providing compensation disclosure on only the reduced number of executive officers. Our findings are summarized below:

Number of Form S-1 Registration Statements: 9
Number of S-1s in which CD&A was Omitted: 7
Number of S-1s with CD&A and also reporting on Five Executive Officers: 2

All of the nine filers recited in their Form S-1s that they were EGCs, but one filer specifically stated that they would not be taking advantage of the lessened EGC requirements. Most of the filers which did not provide a CD&A also reported only on the minimum number of three officers but some did report on more than three officers including one filer which expressly stated in their S-1 that they were voluntarily reporting on an additional executive officer.

What Next?

Companies that are contemplating an IPO will want to consider what level of executive compensation disclosure to provide in light of the JOBS Act. Similarly, companies that complete the IPO process and qualify as an EGC will need to determine post-IPO whether or not to take full advantage of the JOBS Act reduced executive compensation requirements. Some of these decisions of course may be affected by the EGC's specific factual circumstances.

As noted above, the SEC is required to review and analyze Regulation S-K including specifically how to make the registration process more efficient and less burdensome for EGCs, which deadline is rapidly approaching. Companies will want to monitor these developments and consider providing input into this process especially during any public comment period.

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