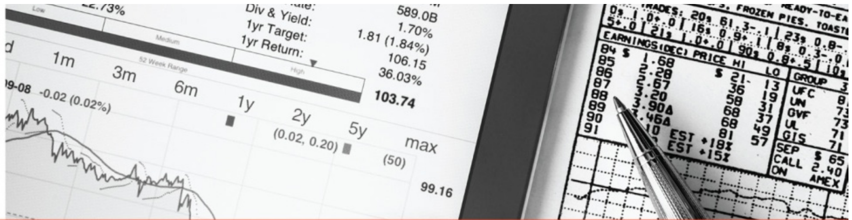
Practice Note



The FAST Act's Amendments to the Securities Act: Practical Implications for Issuers and Underwriters

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The Fixing America's Surface Transportation Act (FAST Act), which was enacted on December 4, 2015, includes a number of changes geared toward streamlining capital formation for middle-market companies. Among these changes are amendments to the Securities Act of 1933 (Securities Act) that may aid emerging growth companies (EGCs) in the process of going public, will allow limited forward incorporation by reference on Form S-1 for smaller reporting companies (SRCs)—a class that is largely comprised of companies with large ownership stakes held by one or more large investors—and provide a new resale exemption for private placements of securities, the proceeds of which may be used for general corporate purposes or to fund specific projects, such as acquisitions. This Sidley *Practice Note* discusses some of the practical implications of these changes for issuers and underwriters.

Executive Summary

EGCs may benefit from a number of FAST Act provisions. The FAST Act reduces the time that the registration statement is required to be publicly filed before the commencement of a roadshow for an initial public offering (IPO). The FAST Act also eliminates certain EGC disclosure requirements and expands the grace period during which a company no longer meeting EGC requirements may retain EGC status.

The FAST Act permits SRCs to incorporate by reference future filings under the Securities Exchange Act of 1934 (Exchange Act) into Securities Act registration statements on Form S-1. This measure primarily benefits shelf registration statements covering resales and best efforts primary offerings.

The FAST Act establishes a new resale exemption, Section 4(a)(7) of the Securities Act, that is modeled after the existing "Section 4 (a)(1½)" exemption but includes some additional requirements that may favor continued reliance on the Section 4(a)(1½) exemption. The new exemption does include some features that, for some, may make it more attractive than the Section 4(a)(1½) exemption.

Changes Affecting EGCs

The Jumpstart Our Business Startups Act (JOBS Act), which was enacted on April 5, 2012, amended the Securities Act to create a new category of issuer, the "emerging growth company," with benefits not enjoyed by other Securities and Exchange Commission (SEC) registrants. An EGC is generally a company with less than US $1 billion in annual revenue that has not gone public or has gone public since late 2011.[1]

Revised IPO Filing Requirements

EGCs enjoy the benefit of submitting to the SEC draft registration statements for confidential review before making a public filing in connection with an IPO. The FAST Act reduces the minimum number of days, from 21 to 15, that the registration statement is required to be publicly filed before the commencement of any roadshow for the IPO.

[1] For a discussion of the provisions of the JOBS Act, see Sidley Austin LLP's client update, dated March 30, 2012.

This shorter minimum time period provides more flexibility in the conduct of an EGC's IPO. However, taking advantage of the shortened minimum time period may not always be in the company's best interest.

Advantages	**Disadvantages**
Longer period of confidential review.	Shorter period for financial and market analysis while in registration before the offering.
Delayed public dissemination of confidential or sensitive information.	Less time for public to become aware of unique or little-known points regarding company or offering.
Additional flexibility, allowing roadshow to be moved forward in the event of favorable market changes.	Less flexibility in negotiating and collecting lock-up agreements or shareholder consents.
Shorter waiting period prior to marketing activities allows company to leverage publicity of first public filing.	Less time for word about offering to spread and excitement to build.

Reduced Disclosure Requirements

As required by the FAST Act, on January 13, 2016, the SEC approved interim final rules[2] that revise the general instructions for Form S-1 and F-1 to permit an EGC to omit from its registration statement (or confidential submission) financial information for historical periods that would otherwise be required, provided that the company:

- Reasonably believes that the omitted financial information will not be required in Form S-1 or F-1 at the time of the contemplated offering; and
- Amends the registration statement to include all financial information required by Regulation S-X prior to the distribution of the preliminary prospectus to investors.

To illustrate, under the FAST Act, an EGC that confidentially submits a draft registration statement or files a registration statement in December 2016 for an IPO that it does not expect to launch before April 2017 may omit audited financial statements for 2014 from its registration statement. However, the EGC must include in its confidential submission or registration statement the interim, unaudited financial statements that are required to be filed in December even though they will not be included in the EGC's registration statement at the time its IPO is launched. This is due to staff guidance that an EGC may not omit interim, unaudited financial statements from its confidential submission or registration statement for a period that is part of a longer period that will be presented at the time of the contemplated offering. It is also worth noting that the SEC staff allows an EGC to omit financial statements of an acquired business from its confidential submission or registration statement if it reasonably believes that such statements will not be required at the time of the contemplated offering.

Preparing financial statements that comply with Regulation S-X can be costly and time-consuming. Accordingly, this change may enable EGCs to benefit from reduced registration costs, such as auditing and legal costs, and by shortening the time necessary to complete the registration statement. Underwriters may also benefit from reduced due diligence costs. On the other hand, some may argue that, by not permitting the exclusion of interim, unaudited financial statements that will not be used in the offering, the FAST Act does not go far enough in reducing unnecessary costs. This new provision may also benefit EGCs by limiting the public dissemination of sensitive material financial information to what is necessary when its securities offering is conducted.

At the same time, it may be beneficial for EGCs and financial intermediaries to forgo this accommodation. For example, it might prove beneficial to include earlier financial information for marketing purposes, e.g., to show longer business trends or provide better comparisons to comparable companies (which may include non-EGC

[2] http://www.sec.gov/rules/interim/2016/33-10003.pdf

issuers). In the case of an acquired business, it may be useful to provide more information about that business than would be required at the time of the offering. EGCs and underwriters making these decisions should consider both marketing needs and factors specific to the issuer and the type of offering.

Expanded Grace Period for EGC Status

Prior to the enactment of the FAST Act, the SEC staff interpreted the JOBS Act to allow an EGC that publicly filed a registration statement to complete its IPO as an EGC. The FAST Act expands this grace period, providing that if an EGC loses its EGC status[3] after it submits a draft registration statement or publicly files a registration statement, the company continues to be treated as an EGC until the earlier of the date on which the company completes its IPO or one year after the date on which the company ceases being an EGC.

This expanded grace period primarily benefits a company that qualifies as an EGC at the time it submits a draft registration statement to the SEC for confidential review but loses its EGC status prior to its IPO. For example, an EGC will lose its EGC status if, in the time between the submission of the draft registration statement and its IPO, a fiscal year ends in which revenues exceed US $1 billion.

By moving the SEC staff's grace period back from the time of publicly filing a registration statement to the time of confidentially submitting a draft registration, the FAST Act expands opportunities for companies to conduct their IPO as EGCs. This is particularly true for a company that is an EGC at the time it would confidentially submit its draft registration statement with the SEC, but knows or is concerned that it will not be an EGC at the time it publicly files its registration statement with the SEC or conducts its IPO.

Forward Incorporation by Reference on Form S-1 for SRCs

The Securities Act and SEC regulations make accommodations for a class of issuers known as "smaller reporting companies." An SRC is a company with (i) a public float of less than US $75 million calculated as of the last business day of its most recently completed second fiscal quarter or, in the case of an initial registration statement, calculated as of a date within 30 days of the date of the filing of that registration statement or (ii) if its public float is zero, annual revenues of less than US $50 million during its most recently completed fiscal year for which audited financial statements are available. The majority of SRCs file their registration statements on Form S-1, as they are unable to satisfy the transaction requirements of Form S-3.

As required by the FAST Act, on January 13, 2016, the SEC approved interim final rules[4] that revise Form S-1 (but not Form S-11 or Form F-1) to permit SRCs to incorporate by reference into their registration statements reports that SRCs file under the Exchange Act after the effective date of the registration statement. Prior to the FAST Act, SRCs were only able to incorporate by reference Exchange Act filings made on or prior to the effective date of their registration statements. To use forward incorporation by reference, an SRC must meet existing eligibility requirements and conditions for historical incorporation by reference.[5]

This change is of limited benefit to SRCs. It does not enable SRCs to maintain shelf registration statements for delayed primary offerings, as they are required to be registered on Form S-3 by Rule 415(a)(1)(x). Forward incorporation by reference may assist if an Exchange Act filing is required after the time a Form S-1 registration statement for a firm commitment primary offering is filed and before the related offering closes. This measure may simplify the administration of shelf registration statements covering resales or best efforts offerings on Form S-1.

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[3] A company qualifies as an EGC until the earliest of (a) the last day of the fiscal year during which its total annual gross revenues do not equal or exceed US $1 billion, (b) the last day of the fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement, (c) the date on which the issuer has, during the previous three-year period, issued more than US $1 billion in nonconvertible debt and (d) the date on which the issuer is deemed an accelerated filer.

[4] https://www.sec.gov/rules/interim/2016/33-10003.pdf

[5] An SRC is eligible to use incorporation by reference if it (a) is required to file Exchange Act reports, (b) has filed all reports and other materials required under the Exchange Act during the prior 12 months (or for such shorter period that the registrant was required to file such reports and materials), and (c) has filed an annual report for its most recently completed fiscal year. Additionally, the SRC must maintain a website where investors can access its Exchange Act reports and must also state in its prospectus that all documents subsequently filed by the registrant pursuant to Section 13(a), 14, or 15(d) of the Exchange Act prior to the termination of the offering shall be deemed to be incorporated by reference into the prospectus. Certain SRCs such as blank check issuers, shell companies or penny stock issuers cannot incorporate by reference.

The New Section 4(a)(7) Resale Exemption

The FAST Act added a new resale exemption, Section 4(a)(7), to the Securities Act. Under this new exemption, an offer or sale of securities does not need to be registered with the SEC as long as the following criteria are met:

- **Seller Requirements:** The seller is a person or entity other than the issuer or a direct/indirect subsidiary of the issuing company.
- **Bad Actor and Statutory Disqualifications:** Neither the seller nor anyone that will receive a commission for their participation in the offering is subject to the "bad actor" disqualification under Regulation D or a statutory disqualification under the Exchange Act.
- **Purchaser Requirements:** Each purchaser is an "accredited investor" as defined in Rule 501(a) under Regulation D.
- **Issuing Company Requirements:** The issuing company is (1) engaged in a business, (2) not in an organizational stage, bankruptcy or receivership, and (3) not a blank check or shell company.
- **Securities Requirements:** The securities (1) belong to a class of securities that has been authorized and outstanding for at least 90 days prior to the commencement of the offering and (2) are not part of an unsold allotment to, or a subscription or participation by an underwriter, or a redistribution.
- **General Solicitation and General Advertising:** The securities are not offered or sold by means of general solicitation or general advertising undertaken by the seller or those acting on its behalf.
- **Additional Requirements for Private Companies:** The seller of securities issued by a company that is not an Exchange Act reporter must provide specified disclosure, including financial information, about the company.

Section 4(a)(7) Compared to Other Exemptions

Prior to the enactment of Section 4(a)(7), resales of securities that were otherwise required to be registered under the Securities Act were undertaken without registration under the Securities Act in reliance on other resale exemptions, including Section 4(a)(1), Section 4(a)(1½), Rule 144 and Rule 144A.

Section 4(a)(1) is the exemption for resales of Securities Act registered securities by non-affiliates of the company that issued the securities.

Section 4(a)(7) is most analogous to Section 4(a)(1½), the term that describes private resales by persons other than the issuer. The hypothesis of the exemption, long acknowledged as valid by the SEC, is that the privacy of the transactions shows there is no distribution involved, which in turn means that the seller is not an underwriter and the sale is not required to be registered under the Securities Act. As usually construed, Section 4(a)(1½) permits sales to a limited number of accredited and other sophisticated investors. Given the existence of Rule 144A, resales in the United States pursuant to Section 4(a)(1½) typically only come into play when privately placed securities allow resales to persons other than qualified institutional buyers (QIBs), as defined in Rule 144A, although it could also be used where public sales under Section 4(a)(1) or Rule 144 would not be available.[6] As a result, Section 4(a)(1½), like Section 4(a)(7), is of particular value to those issuers that privately solicit investors other than QIBs. To perfect the Section 4(a)(1½) exemption, the documentation for the securities will typically have resale restrictions designed to ensure that the resale is done on a private basis only to permitted investors. Because Section 4(a)(7) includes an information requirement applicable to companies that do not file SEC reports, the company's cooperation will be necessary to make the exemption available.

Rule 144 permits unaffiliated sellers to make unregistered public sales as long as the securities have been held for six months, if the securities were issued by an Exchange Act reporting company, or one year, if the securities were issued by a private company. Sellers who are affiliated with the company, referred to as "controlling

[6] Unlike purchasers in Rule 144 transactions, purchasers in Section 4(a)(7), Section 4(a)(1½), or Rule 144A transactions receive restricted securities, which they cannot freely resell.

persons," may also make unregistered public resales in reliance on Rule 144 subject to the public information, volume,[7] manner-of-sale,[8] and notice requirements[9] of the rule.

Rule 144A allows sellers to resell restricted securities to an unlimited number of QIBs and is the most common resale exemption for privately placed securities.

When Section 4(a)(7) is a Better Alternative?

Advocates of Section 4(a)(7) argue that the new exemption is an improvement over Section 4(a)(1½). Their contention is that Section 4(a)(1½) lacks certainty, a perception not shared by all observers. Several provisions of Section 4(a)(7) are more restrictive than Section 4(a)(1½), particularly the bad actor and issuing company disqualifications, the unavailability of the exemption for unsold allotments, and disclosure prescriptions for securities of issuers that do not file Exchange Act reports. An attractive feature of Section 4(a)(7) is that securities sold in reliance on the exemption are "covered securities" within the meaning of Securities Act Section 18,[10] which preempts state-law registration requirements, although certain notice requirements may still apply.

Investors in restricted or control securities—securities acquired through, for example, private placement offerings, Regulation D offerings, employee stock benefit plans, or in exchange for providing "seed money" or start-up capital to an issuer—who wish to sell to the public but do not want to comply with the required holding periods under Rule 144 may also find Section 4(a)(7) useful. Under Rule 144, investors must hold restricted securities for six months (in the case of Exchange Act reporting companies) or one year (in the case of other companies) from the date of purchase before they may be freely resold. Under Section 4(a)(7), investors can sell any securities as long as the *class* of securities to which the securities belong has been outstanding for at least 90 days. Section 4(a)(7) is unlikely to be available to a seller unless the documentation for the original sale permits resales pursuant to Section 4(a)(7) or the issuer consents to, and assists in the seller's compliance with, Section 4(a)(7).

By its terms, Section 4(a)(7) is a safe harbor, meaning that it does not disable reliance on other exemptions, including the Section 4(a)(1½) exemption it so closely resembles.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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[7] Volume of securities being sold must not exceed the greater of: (1) 1% of issuer's outstanding class of securities, (2) the four-week average weekly reported trading volume of such class of securities, and (3) for debt securities, 10% of principal amount of such class or tranche of debt securities.

[8] Equity securities can only be resold through a Section 4(a)(4) broker transaction, transactions with a market maker, or "riskless principal transactions."

[9] Notice is required if the amount of the sale exceeds 5,000 shares or US $50,000 in any three-month period.

[10] Section 18(b)(1) of Securities Act defines covered securities as those securities listed, or authorized for listing, on the Named Markets or on a national securities exchange (or tier or segment thereof) that has "substantially similar" listing standards as the Named Markets.