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Heads Up

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More Than Just Crowdfunding
Two Years After the JOBS Act

by Joe DiLeo and Scott Streaser, Deloitte & Touche LLP

Introduction

The SEC continues to complete its rulemaking mandates under the Jumpstart Our Business Startups (JOBS) Act, whose primary objective is to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." This *Heads Up* focuses on guidance that the SEC staff has issued in response to the JOBS Act since May 8, 2012.[1]

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Emerging Growth Companies

Title I of the JOBS Act created a new category of issuers: emerging growth companies (EGCs). Throughout 2012, the staff in the SEC's Division of Corporation Finance issued FAQs that provide EGC-related interpretive guidance. In addition, in 2013, the staff updated its Financial Reporting Manual (FRM) to add Topic 10, "Emerging Growth Companies." Topic 10 addresses three primary topics: eligibility, scaled disclosure provisions, and foreign private issuers (FPIs).

> **Editor's Note:** The FRM was last updated in February 2014. Although the SEC staff has historically updated the FRM on a calendar-quarter basis, at the SEC Speaks in 2014 Conference, the staff noted that, going forward, it will update the FRM when events and circumstances warrant doing so. For additional information about the SEC Speaks in 2014 Conference, see Deloitte's March 20, 2014, *Heads Up*.

Eligibility

Disqualifying Provisions

An issuer that loses its EGC status must meet all of the reporting requirements for a non-EGC issuer. These requirements include (1) providing three years of audited financial statements (as long as the issuer does not otherwise meet the definition of a smaller reporting company[2] (SRC)) and (2) obtaining an audit of the issuer's internal controls over financial reporting (ICFR). As noted in paragraph 10110.4 of the FRM, an issuer would retain EGC status until the earliest of the following:

- "The last day of the fiscal year in which its total annual gross revenues are $1 billion or more."
- "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" (provided that the EGC does not meet another disqualifying criterion on an earlier date and consequently would no longer be an EGC on the last day of the fiscal year).

[1] For a summary of JOBS Act provisions as well as developments that occurred before May 8, 2012, see Deloitte's April 2, 2012 (updated May 8, 2012), *Heads Up*.

[2] As defined in Rule 12b-2 of the Securities Exchange Act of 1934 and Regulation S-K, Item 10(f).

- "The date on which it has issued more than $1 billion in non-convertible debt[3] in the previous three years."[4]
- "The date on which it becomes a large accelerated filer" (i.e., the EGC's market capitalization exceeds $700 million and is determined on the last day of the issuer's fiscal year.[5]

Editor's Note: Although the JOBS Act created a new type of issuer (i.e., EGC), it did not change the issuer filing status categories that are defined in Rule 12b-2 of the Securities Exchange Act of 1934 (the "Exchange Act"). These categories govern reporting matters such as (1) issuers' deadlines for periodic filings and (2) whether an audit of an issuer's ICFR is required. For example, an EGC's filing deadlines would be determined on the basis of its filing status (i.e., whether it is a large accelerated, accelerated, or nonaccelerated filer). Filing status also is used to determine whether an issuer would be required to obtain an audit of its ICFR under Regulation S-K, Item 308(b), because nonaccelerated filers (and SRCs — because many nonaccelerated filers also qualify as SRCs) are exempt from such a requirement. However, under the JOBS Act, issuers that are accelerated filers and that meet the EGC status requirements would also be exempt from complying with Item 308(b).

Because of increasing stock prices in U.S. markets, an EGC may have a market capitalization that exceeds $700 million, resulting in the loss of its EGC status. In such cases, the issuer would be required to obtain an audit of its ICFR in the year in which it meets the disqualifying criterion. Similarly, if an issuer loses its EGC status because its revenues exceed $1 billion on the last day of its fiscal year, it would need to comply with Item 308(b) unless it is a nonaccelerated filer.[6]

Although the JOBS Act created a new type of issuer (i.e., EGC), it did not change the issuer filing status categories that are defined in Rule 12b-2 of the Securities Exchange Act of 1934.

Confidential Submissions

EGCs can submit a draft registration statement to the SEC for confidential review on EDGAR. An issuer would assess EGC status at the time it submits its initial draft registration statement, and the issuer must file its initial public registration statement at least 21 days before a "road show."[7] The staff clarified in certain of its FAQs that submission for confidential review is not synonymous with the filing of the issuer's registration statement.

Editor's Note: At the SEC Speaks in 2014 Conference, the SEC staff reminded EGCs that draft registration statements submitted for confidential review must be "substantially complete" (i.e., they must contain a signed audit report from the EGC's registered public accountant and meet all line-item requirements for the registration statement, including all required exhibits). For draft submissions, EGCs do not need to include items such as the required signatures of executives and directors, the auditor's consent, and the filing fee, but these are required when the registration statement is initially filed (i.e., the publicly filed registration statement must be complete).

Issuers that lose their EGC status during the confidential review process are not eligible to file under the rules and regulations applicable to an EGC; rather, such issuers must comply with the rules and regulations applicable to non-EGCs. However, if an issuer qualifies as an EGC, the scaled disclosure provisions related to EGCs would continue to apply through the date on which the registration statement is declared effective even if the issuer loses its EGC status during the registration process. An issuer that loses its EGC status cannot regain it.

[3] Paragraph 10110.4 of the FRM defines the term "non-convertible debt" as "any non-convertible security that constitutes indebtedness, whether issued in a registered offering or not. Bank debt generally does not constitute a debt security."

[4] Paragraph 10110.4 of the FRM states, "For purposes of assessing the amount of non-convertible debt securities issued as of any date, an issuer should look at the immediately preceding rolling three-year period" (i.e., not in relation to an issuer's fiscal or calendar year).

[5] For additional information, see Exchange Act, Rule 12b-2(3), "Entering and Exiting Accelerated Filer and Large Accelerated Filer Status."

[6] These conclusions also assume that the issuer did not lose its EGC status within the first year after completing its initial public offering of equity securities and before it files its first Form 10-K, because new public companies are required to comply with Item 308(b) when filing their second Form 10-K.

[7] SEC Rule 433(h)(4) defines a "road show" as "an offer . . . that contains a presentation regarding an offering by one or more members of the issuer's management . . . and includes discussion of one or more of the issuer, such management, and the securities being offered."

> **Editor's Note:** On March 14, 2014, the U.S. House of Representatives Financial Services Committee voted to approve H.R. 3623, the Improving Access to Capital for Emerging Growth Companies Act, and H.R. 4164, the Small Company Disclosure Simplification Act.
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> H.R. 3623, as currently proposed, would allow an issuer that was an EGC at the time it filed its confidential draft registration statement to retain EGC status through the earlier of (1) the date of its initial public offering (IPO) or (2) one year after the issuer loses its EGC status. In addition, the current proposal would permit confidential staff reviews of an EGC's draft registration statements for additional offerings of any securities within one year after its IPO — provided that the initial draft submission and related amendments are publicly filed no less than two days before the EGC issues such securities.
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> H.R. 4164, as currently proposed, would exempt EGCs from the requirement to use XBRL when filing financial statements and other periodic reports with the SEC. The draft legislation would also extend the exemption to other issuers (i.e., non-EGCs) with revenues below $250 million. In addition, the SEC would be required to perform a cost-benefit analysis of XBRL and to report its findings to Congress within one year after the draft legislation is enacted.

If an issuer qualifies as an EGC, the scaled disclosure provisions related to EGCs would continue to apply through the date on which the registration statement is declared effective even if the issuer loses its EGC status during the registration process.

Other Eligibility Issues

Other EGC-related eligibility topics addressed by the FRM include:

- The SEC staff's views on evaluating EGC status eligibility after merger transactions (i.e., after forward and reverse acquisitions).
- Situations in which an issuer loses EGC eligibility (1) between the date of its initial filing and the date when the registration statement is declared effective and (2) after the date on which the issuer completes the first sale of its common equity securities.
- The determination of "whether an issuer is an EGC [when] the subsidiary, and not the parent, meets the requirements of an EGC."
- The effect of a predecessor's ineligibility on a successor.
- An EGC's status when an issuer had a prior reporting obligation under the Exchange Act that no longer exists.

> **Editor's Note:** Paragraph 10120.3 of the FRM indicates that the SEC staff may question an issuer about its EGC status "if it appears the company is engaging in a transaction for the purpose of . . . obtaining the benefits of EGC status indirectly when it is not entitled to do so directly."

Scaled Disclosure Provisions

Financial Reporting

The FRM provides guidance on the number of years that must be presented in (1) financial statements included in different registration statements, (2) selected financial data, (3) the ratio of earnings to fixed charges, and (4) MD&A. The staff also discusses the number of years to be presented in the financial statements of significant acquired companies and equity method investments.[8]

Transition Provisions in Accounting Standards

Under the JOBS Act, an EGC may adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) "if such standard[s] appl[y] to companies that are not issuers." New or revised financial accounting standards are accounting standards issued by the FASB after April 5, 2012. The decision to apply new or revised accounting standards on the basis of the effective dates for

[8] Significance for acquired businesses and equity method investees would be determined in accordance with Regulation S-X, Rules 3-05 and 3-09, respectively.

either public companies or private companies is an accounting policy election. Paragraph 10230.1 of the FRM states that an EGC must make this election when it is first required to file a registration statement, periodic report, or other report and that it must notify the SEC of its election.

An EGC that has elected to apply extended transition provisions related to the implementation of new or revised accounting standards may change its election at any time. In doing so, the EGC would "opt in" to complying with the effective dates applicable to non-EGCs. Once made, this decision is irrevocable and must be applied to all accounting standards (i.e., any standard previously adopted on the basis of private-company effective dates and all future new or revised accounting standards).

Nonissuers may be permitted to early adopt new or revised accounting standards. As a result, a nonissuer's transition basis for adopting a new or revised standard may be the same as an issuer's. Paragraph 10230.1 of the FRM clarifies that EGCs electing to early adopt such new or revised accounting standards would not have "opted in" and therefore would not be required to adopt all prior (and future) new or revised accounting standards as if they were non-EGC issuers (i.e., because the standard expressly permits early adoption for nonissuers).

Under the JOBS Act, an EGC may adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) "if such standards apply to companies that are not issuers."

Editor's Note: Paragraph 10230.2 of the FRM notes that because EGCs are issuers and not private companies, they must comply with all accounting standards that apply to issuers (except that adoption dates may be deferred for EGCs as well). By extension, EGCs may not implement accounting standards that apply only to private companies (i.e., nonissuers), such as private-company accounting alternatives[9] permitted for companies that do not meet the definition of a public business entity.[10]

Foreign Private Issuers

The SEC staff has indicated that EGCs that are FPIs (like FPIs that are not EGCs) cannot report under the *IFRS for Small and Medium-sized Entities* but must apply IFRSs as issued by the IASB.

Access to Capital in Private Offerings

To eliminate the ban on general solicitation and advertising for private offerings, Title II of the JOBS Act directs the SEC to amend Rule 506 of Regulation D ("Rule 506") and Rule 144A of the Securities Act of 1933 ("Rule 144A"). However, the JOBS Act limits the general solicitation and advertising to (1) accredited institutional investors in Rule 506 offerings and (2) qualified institutional buyers (QIBs) in offerings under Rule 144A.

On July 10, 2013, the SEC issued a final rule that amends Rule 506 to allow issuers to use general solicitation and advertisements to market their securities if they have taken reasonable steps to confirm that the purchasers of the securities are accredited investors.[11] An SEC fact sheet gives examples of steps entities can consider taking to confirm that investors are accredited, including:

- Reviewing copies of investors' IRS forms that report income.
- Receiving investors' written representation that they "will likely continue to earn the necessary income in the current year."
- Obtaining written confirmation from certain parties, such as registered broker-dealers and investment advisers, attorneys, or certified public accountants, that the issuer "has taken reasonable steps to verify the purchaser's accredited status."

[9] Recent examples of standards containing private-company alternatives include FASB Accounting Standards Update Nos. 2014-02, *Accounting for Goodwill*, and 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach*.

[10] As defined in FASB Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity — An Addition to the Master Glossary*.

[11] Regulation D, Rule 501, indicates that a person qualifies as an accredited investor if he or she has either (1) an individual net worth or a joint net worth with a spouse that exceeds $1 million at the time of the purchase, excluding the value (and any related indebtedness) of a primary residence, or (2) an individual annual income that exceeded $200,000 in each of the two most recent years or a joint annual income with a spouse that exceeded $300,000 for those years, as well as a reasonable expectation of the same income level in the current year.

Editor's Note: At the SEC Speaks in 2014 Conference, the SEC staff emphasized that the determination of whether an investor is accredited is based on sufficient appropriate evidence. The staff gave an example in which obtaining a potential investor's bank statement that showed a significant amount of cash may not be sufficient if the issuer did not also obtain evidence of the amount of the significant liabilities (e.g., by obtaining the investor's credit report or other evidence). The staff cautioned that the SEC's Division of Enforcement is monitoring the market to ensure that issuers are soliciting accredited investors.

The final rule also amends Rule 144A to allow issuers to offer securities to investors that are other than QIBs if the issuers reasonably believe that such investors are QIBs. Further, the final rule adds to Form D a box that issuers should check to indicate that they are relying on the provisions that allow general solicitation and advertising in a Rule 506 offering.

Certain provisions of the JOBS Act, such as many in Title I, are "self-executing" and may be applied before the SEC makes conforming amendments to its rules and regulations. However, the JOBS Act's crowdfunding provisions require rulemaking and on April 23, 2012, the SEC staff warned that until rules are adopted, crowdfunding transactions are unlawful.

Crowdfunding

Certain provisions of the JOBS Act, such as many in Title I, are "self-executing" and may be applied before the SEC makes conforming amendments to its rules and regulations. However, the JOBS Act's crowdfunding[12] provisions require rulemaking and on April 23, 2012, the SEC staff warned that until rules are adopted, crowdfunding transactions are unlawful.

On October 23, 2013, the SEC voted unanimously to issue a proposed rule to implement requirements in Title III of the JOBS Act that would permit eligible companies to use crowdfunding to offer and sell securities. An individual would be allowed to use crowdfunding to invest in eligible companies, subject to certain thresholds, on the basis of the individual's annual income or net worth (with an overall cap of $100,000 per individual). The amount of money a company can raise through crowdfunding offerings would be limited to $1 million in a 12-month period. Companies that offered their securities in crowdfunding transactions would (1) need to transact through SEC-registered intermediaries, (2) file certain information (including their reviewed or audited financial statements, depending on the amounts offered and sold during a 12-month period), and (3) disclose certain other information about their offers.

Companies prohibited from using crowdfunding transactions to offer and sell securities include those organized outside the United States and its territories, companies already subject to reporting requirements under the Exchange Act, and investment companies (including hedge funds).

Comments on the proposed rule were due by February 3, 2014.

Small-Company Capital Formation

To implement the provisions in Title IV of the JOBS Act, on December 18, 2013, the SEC issued a proposed rule that would exempt offerings of securities under Regulation A (up to $50 million annually) from the registration requirements of the Securities Act of 1933. The proposed rule specifies (1) which issuers are eligible for the exemption, (2) the content and filing requirements for issuers' offering statements, and (3) issuers' ongoing reporting requirements.

Under Regulation A, an issuer is currently permitted to offer up to $5 million of securities in a 12-month period, and no more than $1.5 million of those securities may be offered by the company's security holders. The proposed rule would update and expand the exemption by creating two tiers of offerings under Regulation A:

- Tier 1 would consist of offerings that satisfy Regulation A's current requirements (described above).
- Tier 2 would consist of securities offerings of up to $50 million in a 12-month period, with no more than $15 million offered by an issuer's security holders.

[12] Crowdfunding is a method of raising capital, typically over the Internet, by soliciting small individual contributions from a large number of people.

Under both tiers, companies would be subject to Regulation A's current basic requirements, including those related to issuer eligibility and providing financial statements and disclosures. For Tier 1 offerings, an issuer would need to provide financial statements in the offering statement but would not be required to provide audited financial statements unless the issuer had obtained an audit for another purpose. Such an audit may be in accordance with either PCAOB standards or U.S. GAAS (i.e., AICPA standards). In addition, the proposed rule would require issuers of Tier 2 offerings to provide audited financial statements, and the audits would need to be performed in accordance with PCAOB standards (i.e., Tier 2 issuers would not be permitted to file financial statements that were audited in accordance with the AICPA's standards). In addition, auditors of Tier 1 and Tier 2 issuers would be required to comply with the SEC's independence standards but would not have to be registered with the PCAOB.

Editor's Note: Issuers under the proposed revisions to Regulation A would most likely meet the FASB's definition of a public business entity. Such issuers may have previously been considered private companies that had incorporated private-company accounting alternatives into their financial statements. As public business entities, issuers would need to revise their financial statements to reverse the effects of applying private-company alternatives, and these financial statements may need to be reaudited (if they have already been audited).

In addition to satisfying Tier 1 requirements and providing audited financial statements, issuers of Tier 2 offerings would need to fulfill ongoing reporting obligations, including filing annual audited financial statements and semiannual unaudited financial statements. Issuers of Tier 2 offerings would also be required to provide current-event updates for significant developments. Examples of significant developments include changes of control, changes in the principal executive officer and principal financial officer, fundamental changes in the nature of the business, material transactions or corporate events, and unregistered sales of 5 percent or more of outstanding equity securities.

The proposed rule also describes types of issuers that would be ineligible to use Regulation A to offer their securities. For example, the Regulation A exemption would not be available to companies that (1) are currently SEC reporting companies or that are organized (or whose principal place of business is located) outside the United States or Canada, (2) have no specific business plan or purpose, or (3) are subject to disciplinary action by the SEC.

Editor's Note: At the SEC Speaks in 2014 Conference, the SEC staff indicated that it will be reviewing feedback on the crowdfunding and Regulation A proposed rules — individually and together as a "package" of rulemaking — to ensure that the final rules help the Commission achieve its goal of more efficient capital raising for issuers.

Comments on the proposed rule were due by March 24, 2014.

On the Horizon

The SEC has indicated that the Commission plans to amend rules during 2014 to reflect the increase in the shareholder registration threshold from 500 to 2,000 for issuers that are not banks or bank holding companies (this threshold became effective when the JOBS Act was signed into law). In addition, the SEC will continue to assess feedback on the proposed rules discussed above and will work to issue final rules to fulfill its congressionally stipulated mandates under the JOBS Act.

The SEC has indicated that the Commission plans to amend rules during 2014 to reflect the increase in the shareholder registration threshold from 500 to 2,000 for issuers that are not banks or bank holding companies (this threshold became effective when the JOBS Act was signed into law).

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