Client Alert

June 4, 2012

Legislation of Interest

The Jumpstart Our Business Startups Act: Possible Implications for D&O Insurers

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the "JOBS Act") into law. Like Dodd-Frank, the entire scope of the JOBS Act will not be known until after significant rule making by the SEC, which seems nonplussed, as reflected in Mary Schapiro's recent comments that the JOBS Act would "weaken investor protection" and that "we should not walk backwards here." Unlike the 2,300+-page Dodd-Frank Act, the JOBS Act is an approachable twenty-two pages in length.[1] Large corporate law firms have been quick to assemble summaries of the JOBS Act and we leave that to them, only noting that some summaries are more helpful than others.[2]

While cognizant of the industry's tendency to overreact to the issue-du-jour, this appears to be the real deal – legislation that could materially impact the profitability of D&O insurers (either positively or negatively) depending on the quality and speed of their reactions. We discuss three possible implications for D&O insurers. In particular, we explore whether the JOBS Act will result in (a) more lower-quality IPOs; (b) public-company securities exposure for private companies; and (c) increased investor lawsuits for private funds.

I: Will Emerging Growth Company IPOs (as a class) be Riskier?

Probably the most talked about provision of the JOBS Act is Title I (the so-called IPO On-Ramp). To address the absolute and relative decline in the number of IPOs in the U.S. in recent years, the JOBS Act is designed to make going public in the U.S. easier and more attractive – at least for issuers that qualify as "Emerging Growth Companies."

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[1] A copy is available at: http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[2] Skadden's summary (http://www.skadden.com/Index.cfm?contentID=51&itemID=2705) is particularly helpful.

The primary characteristic of an Emerging Growth Company is that is has revenues of less than $1 billion. To put this into perspective, the No. 500 company in the 2012 Fortune 500 list had $4.7 billion in revenues and the No. 1000 company had $1.2 billion. But, a ZACKS stock screen for companies with less than $1 billion in revenues yielded 4,140 matches. Using this for context, Congress appears to have cut a wide swath in defining Emerging Growth Companies.

Emerging Growth Companies can now go public with less disclosure and a reduced post-IPO regulatory burden. This includes (a) requiring only two (versus three) years of pre-IPO audited financial statements; (b) no requirement for auditor attestation of internal controls under SOX 404(b); (c) no say-on-pay shareholder advisory voting; and (d) no need to comply with any new or revised financial accounting standard until private companies are required to comply with that standard. Importantly, an Emerging Growth Company can also "test the waters" prior to going public by confidentially submitting a draft registration statement to the SEC, so long as the initial submission and all amendments are publicly filed with the SEC at least 21 days prior to the IPO road show.

Thus, at least in theory, a large number of private companies will now be able to go public with less cost, less risk, less disclosure and less post-IPO "hassle." But, will they? The JOBS Act also makes it easier for private companies to raise capital while remaining private. No cost and no risk is obviously preferable to less cost and less risk. Moreover, Emerging Growth Company IPOs could receive lower valuations if investors discount for less rigorous financial reporting, controls and corporate governance.[3] If such is the case, prospective issuers may be more selective in availing themselves of a reduced IPO burden[4] and more targeted D&O pricing would likely follow. After all, if only some Emerging Growth Company IPOs take advantage of the relaxed requirements, this necessarily produces an objective, common-sense basis to charge higher rates for those that do.

Nonetheless, we suspect investor apathy will trump any movement to discount Emerging Growth Company IPOs. Therefore we expect most Emerging Growth Company IPOs will take advantage of the relaxed requirements in the JOBS Act to the extent possible. As such, the potential for restatements or outright fraud involving Emerging Growth Company IPOs will increase, if one assumes restatements and outright fraud are less likely in companies with robust disclosures, controls and governance. Only time will tell if this logic holds true – but one could point to the post-SOX period as proof of the inverse and extrapolate from there.

Traditional market wisdom holds that, all else being equal, the better the D&O submission and the greater the transparency, the lower the D&O premium. Whether brokers and insureds will recognize this as a double-edged sword remains to be seen. However, the JOBS Act implies an upward rate adjustment is warranted for Emerging Growth Company IPOs.

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[3] Sarah Johnson, *A New Risk Factor: The JOBS Act,* CFO Magazine, May 15, 2012 a*vailable at* http://www3.cfo.com/article/2012/5/regulation_jobs-act-risk-disclosures-ipos.

[4] For example, a Form S-1 recently filed by LegalZoom (an Emerging Growth Company) noted that "under the JOBS Act, emerging growth companies can also delay adopting new or revised accounting standards until such time as those standards apply to private companies. We have irrevocably elected not to avail ourself of this exemption from new or revised accounting standards and, therefore, will be subject to the same new or revised accounting standards as other public companies that are not emerging growth companies."

II: The Line Between Public and Private is Blurred

Private companies will now have flexibility to remain private much longer, and build a much larger shareholder base before going public. Thus, over time, the "top end" of the private company market will look and feel more public. The JOBS Act eliminates the long-standing prohibition on general solicitation and general advertising that has applied to private offerings conducted in reliance on Rule 506 of Regulation D under the 1933 Act, so long as all purchasers are accredited investors. It further directs the SEC to require an issuer who relies on Rule 506 to take "reasonable steps" to verify that purchasers of the securities are accredited investors and to create methods by which issuers can verify an investor's accredited status. Significantly, these Rule 506 changes are not restricted to small or emerging growth companies, but rather apply to all types of issuers relying on Rule 506. The Act also (a) raises the number of shareholders of record that would trigger public company reporting requirements under the Exchange Act from 500 to 2,000 (excluding crowdfunding holders and employee holders who received company securities as part of an executive compensation plan) and (b) raises the 12-month Regulation A offering limit from $5 million to $50 million. Title III of the Act also facilitates securities-based "crowdfunding."[5]

Some have opined about which private companies are likely to use which exemption, but prognosticating in this area will remain a tricky business until the SEC weighs in fully via rule making.[6] Regulation A has been a relatively little-used exemption, a trend we expect to continue given that companies seeking to take advantage of the new offering limit will still need to file annual audited financial statements and comply with any other periodic reporting requirements that the SEC may prescribe. By contrast, Rule 506 offerings have long been the most popular of the three types of non-registered offerings available under Regulation D and we expect that to continue.

A brief review of statistics regarding Regulation D offerings supports this conclusion. On April 12, 2012, the Division of Risk, Strategy and Financial Innovation of the SEC issued a report entitled "Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption." It analyzes information obtained from Forms D filed with the SEC from January 2009 through March 2012. Significant findings include the following:

- There were 29,269 new and amended Regulation D filings in 2010 and more than 10,000 in the first quarter of 2011. No other offering method was used even a tenth as frequently.
- The average Regulation D offering is around $30 million; the median is around $1 million.
- Less than one-third (29%) of issuers are pooled investment funds, of which a little more than half (or 16% of all Regulation D offerings) are hedge funds.
- Regulation D issuers tend to be small; of issuers that disclose revenues, only 1.8% of offerings are by issuers that report more than $100 million in revenue, whereas 48% of SEC registrants report revenues above $100 million.
- 91.6% of issuers filed under Rule 506.

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[5] This differs from the type of service-based crowdfunding conducted through Kickstarter.com and the like.

[6] To date, SEC Chairwoman Mary Schapiro has been a fairly outspoken opponent of the JOBS Act and has indicated that the suggested timeframes for SEC rulemaking are unreasonable and unlikely to be met.

- Capital raised through Regulation D offerings is more than twice as large as public equity offerings as well as each other category of unregistered offerings.
- Public offerings fell by 17% from 2009 to 2010, while private issuances increased by 31%.
- There were no nonaccredited investors in 90% of Regulation D offerings.
- The median number of investors is four, with nearly 90% of offerings involving less than thirty investors and 99% involving less than 155 investors.

Whether Regulation A offerings will become more popular with the new $50 million offering cap or whether crowdfunding will be broadly adopted is unclear. However, under almost any scenario, private company submissions are now more likely to include companies with (a) plans for, or a history of, large securities offerings; (b) a larger shareholder base;[7] (c) shareholders with little or no prior substantive relationship with management or the company; and (d) some significant number of unsophisticated shareholders to the extent crowdfunding is utilized.

No doubt the line of demarcation in private company forms between "public" and "private" will be tested. Typically whether a company is "public" or "private" is determined by the presence of one or more registered offerings, a distinction generally found in policy exclusions. Three such exclusions, sampled from various insurers, are listed below for reference:

1. arising from, based upon, or attributable to any public offering of securities of an Insured Organization or the purchase or sale of such securities subsequent to such public offering; provided that this exclusion shall not apply to any Claim: (a) for a Wrongful Act in an offering of securities of an Insured Organization to any accredited investor in a transaction that is exempt from registration under the Securities Act of 1933 ("accredited investor" shall have the meaning specified for such term in Rule 501 of Regulation D of the General Rules and Regulations promulgated under the Securities Act of 1933); or (b) made by any security holders of an Insured Organization for the failure of the Insured Organization to undertake or complete an initial public offering of securities of such Insured Organization.

2. any actual or attempted offering, solicitation, sale, distribution, or issuance of debt or equity securities by an Entity or any alleged violation of the Securities Act of 1933, the Securities Exchange Act of 1934, any rules or regulations of the Securities and Exchange Commission promulgated thereunder, any other federal, state, local or provincial statute or common law relating to securities, or any rules or regulations promulgated thereunder, all as amended; however this Exclusion shall not apply with respect to any offering, solicitation, sale, distribution, or issuance of securities in a transaction that is exempt from registration under United States Securities law and any applicable state laws, rules, or regulations. (Exempt under Federal and State)

3. based upon, arising from or in consequence of (a) any public offering of securities issued by any Organization or Outside Entity, or (b) the purchase or sale of any publicly traded securities for which the Organization is subject to the Securities Exchange Act of 1934, provided that this Exclusion (A)(7) shall not apply to Loss: (i) based upon, arising from or in consequence of an offering, sale or purchase of securities that are not required to be registered under the Securities Act of 1933 or any similar foreign law that regulates the offering, sale or purchase of securities; (ii) on account of a Claim made by any security holder of an Organization for the failure of the Organization to undertake or complete the initial public offering or sale of securities of the Organization; or (iii) for any Wrongful Act relating to an Organization's preparation for any public offering, including any road show

[7] Another area of uncertainty is how the JOBS Act will impact secondary markets such as sharepost.com, which make a market for private company shares, especially given that 506A and crowdfunding offerings are generally restricted.

> presentation to potential investors or other similar presentation, made by the Organization and its Executives via any medium in connection with such public offering, if such offering does not occur.

These "offering exclusions"[8] are critical provisions in private company D&O policies and insurers and brokers alike will surely be asking in-depth questions about whether (and to what extent) these exclusions need to be re-worded to ensure the intended scope of coverage is met. Using the above exclusions as examples, a few questions come to mind. If securities in a generally solicited offering intended to be exempt under 506 are inadvertently sold to an unaccredited investor, will any related securities suits be covered? Should any "large" or otherwise risk-altering offering (i.e. an offering over a certain amount or an offering which could double the shareholder base) be covered prospectively, or only after the underwriters have had a chance to review and price for such an offering? Is there coverage for any wrongful act involving "testing the waters" prior to going public by confidentially submitting a draft registration statement to the SEC and publicly filing (or not) the initial submission and all amendments at least 21 days prior to the IPO road show? In other words, is testing the waters for an IPO the same as preparing for one?

In view of the above, we expect private company rates will trend upward as a result of the JOBS Act. Over time, the ability to generally solicit investors in Rule 506 offerings and Regulation A's increased offering cap may lead to increased frequency and severity in private company securities claims, while crowdfunding should remain a frequency/SIR issue due to the limited offering sizes. The more immediate concern for D&O insurers and brokers would appear to be the need for changes to the "offering exclusions" contained in most (if not all) private company forms.

III: Hedge Funds are Private Companies Too

A possibly overlooked aspect of the JOBS Act is its effect on private funds (i.e. hedge funds, private equity or venture capital.) After all, these funds are private issuers. Rule 506 has long provided an exemption from registration under the Securities Act of 1933 for the offer and sale of interests in private funds, so long as sales were made primarily to accredited investors and the issuer did not engage in any general solicitation or general advertising. Under Rule 502(c), general advertising includes, but is not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising."

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[8] Interestingly, while Section 4(2) of the Securities Act of 1933 exempts from registration any "transactions by an issuer not involving any public offering," the term "public offering" is never actually defined in the '33 Act. As the U.S. Supreme Court observed nearly 20 years after the '33 Act was passed: "The Securities Act nowhere defines the scope of § 4([2])'s private offering exemption. Nor is the legislative history of much help in staking out its boundaries." *SEC v. Ralston Purina Co.*, 346 U.S. 119, 122 (1953). Ironically, neither was the court's decision in *Ralston Purina*, which merely held that whether an offering is public "should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering." After *Ralston Purina*, the securities bar applied a case-by-case "facts and circumstances" analysis, focusing on: (a) number of offerees; (b) financial sophistication of purchasers or their investment advisers; (c) ability to bear economic risk of a loss of their investment; (d) information about the issuer or access to such information; and (e) investment intent – did the investor intend to invest? Ultimately, this led the SEC to promulgate the safe harbor provisions of Regulation D.

No longer. Now a private fund, like other private issuers, can generally solicit and advertise with respect to fund interests sold pursuant to Rule 506 so long as such interests are ultimately sold only to "accredited investors." Gone are the days of cautionary "cooling off periods" used when courting potential investors with whom the manager had no substantive pre-existing social or business relationship. Gone is the inability to post information about product offerings on the manager's website. We probably will not soon see the nightly business round-up brought to you by Bain Capital or catch a baseball game at Magnetar Field – but it appears that private fund managers will be able to communicate information about fund offerings and performance in the press and on their websites, provided actual subscriptions are limited to accredited investors.

We expect many fund managers will continue to avoid advertising – especially large, more established funds. First, such funds view advertising (especially general advertising) as a tactic to which only the weak need resort (not unlike the view many managers hold of soliciting fund of funds money.) After all, to some investors there is nothing more enticing than the chance to get into an exclusive fund (think Madoff). Second, many funds guard details of their investment strategies, historical performance or forecasts of future performance for fear of disclosing proprietary information. Third, counsel to larger fund managers will likely view the risk/reward of advertising as unfavorable, given the severe consequences of an inadvertent sale to a nonaccredited investor and the increased risk of investor lawsuits claiming that advertising materials were false or misleading. Thus, it is more likely managers of smaller, less established funds will avail themselves of the ability to generally advertise – at least initially.

We also expect subscription agreements to remain iron-clad. If a fund does advertise, such fund's subscription agreements will likely be amended to include a representation by the investor that he/she, in making the decision to invest, did not rely on any statements made in the fund's advertising. Nonetheless, this is an imperfect safeguard. Whenever a manager makes statements (especially self-serving statements) outside of the offering documents, such statements become fodder for the traditional investor claim (i.e. "I know the subscription document says X, but on a phone call or during a meeting, you told me Y.") After all, citing an authorizing or exculpatory provision in a subscription agreement as an affirmative defense becomes more difficult to the extent the aggrieved investor alleges false or misleading advertising induced him/her into signing such agreement in the first place.

IV. Summary

The JOBS Act presents risk (and opportunity) to D&O insurers. It appears there will be more lower-quality IPOs, more private companies facing public-company-like securities exposure and an increase in investor lawsuits against private fund managers, especially managers of smaller, less-established or less-successful funds.

If you have any questions concerning the JOBS Act or any of the above, please do not hesitate to contact us.

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