The Jumpstart Our Business Startups Act and Its Impact on Equity Research Analysts

I. Overview

On Thursday April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the “JOBS Act”) into law, adopting measures designed to facilitate both public and private capital formation. The legislation is intended, in part, to encourage “emerging growth companies” (companies with less than $1 billion in revenue) (“EGCs”) to go public. As enacted, the JOBS Act significantly liberalizes the regulations governing research analysts and their coverage of these companies. The purpose of this memorandum is to provide an overview of the impact of the JOBS Act on the regulatory scheme governing equity research analysts and the potential liability arising from the issuance of pre-deal research.

In short, under the JOBS Act, the publication of pre-deal research regarding an offering by an EGC is now expressly permitted. However, although the JOBS Act breaks new ground by permitting pre-deal research on EGCs, the standards for imposing liability under Section 17 of the Securities Act and Section 10(b) of the Exchange Act with respect to pre-deal research reports are consistent with traditional standards governing post-deal research reports. As described in greater detail below, where research analysts publish good faith reports accompanied by meaningful cautionary language, it will be difficult for plaintiffs to successfully prosecute a claim based on the opinions contained in the research reports.

A. Emerging Growth Companies

The JOBS Act defines EGCs as having total annual gross revenues of less than $1 billion for their most recently completed fiscal year. An EGC will retain its status until the earlier of: (i) the last day of the fiscal year during which the company had total annual gross revenues of $1 billion or more, (ii) the last day of the fiscal year following the fifth anniversary of the date of the company’s initial public offering, (iii) the date on which the EGC has issued more than $1 billion in non-convertible debt during the previous three-year period, or (iv) the date on which the company qualifies as a “large accelerated filer” (a company that has been reporting for at least a year, has an unaffiliated public float of at least $700 million, and has filed at least one annual report).

If a company’s IPO occurred on or before December 8, 2011, then it would not qualify as an EGC. A company can determine not to avail itself of the benefits conferred on EGCs under the JOBS Act.

B. The Existing Regulatory Landscape

In the post-Enron and WorldCom regulatory environment, research analysts have become subject to a strict set of rules intended to prevent perceived conflicts of interest from impairing research coverage. In 2002, Congress passed the Sarbanes-Oxley Act. SOX Section 501 directed the SEC, or (at the SEC’s discretion) the NASD and NYSE, to promulgate rules designed to address potential conflicts of interest that may arise when research analysts recommend equity securities.

Also in 2002, the NASD promulgated Rule 2711, which establishes research “blackout periods” — specified periods of time following an initial public offering, a secondary offering or the release or
termination of a lock-up agreement, after which a manager or co-manager of the offering may not publish research with respect to the company making the offering. Rule 2711 also prohibits research analysts from participating in efforts to solicit investment banking business; prohibits research analysts from participating in road shows related to an investment banking transaction; and bars research analysts from communicating with a current or prospective customer in the presence of investment bankers or company management about an investment banking transaction.

In 2003, the SEC adopted Regulation AC, which requires research analysts to certify that the opinions expressed in their reports accurately reflect their personal views, and to disclose whether their compensation is in any way tied to the positions adopted in their reports.

Finally, in late 2003, following investigations by federal and state regulatory authorities, a number of prominent Wall Street banks entered into the Global Research Analyst Settlement (the "Research Settlement"). The terms of the Research Settlement, which are reflected in a federal court judgment for each of the settling banks, are similar to certain of the provisions of NASD Rule 2711 concerning conflicts. However, the Research Settlement differs from Rule 2711 in that it imposes stricter firewalls between the research and investment banking departments of a firm, and requires chaperoning of most communications between those departments by the firm’s internal legal or compliance staff.

II. Research Reports on EGCs Under the JOBS Act

Section 105 of the JOBS Act significantly reduces, but does not eliminate, the constraints imposed upon research analysts with respect to research coverage of EGCs.

A. Pre-Deal Research Reports

The JOBS Act now permits research analysts to issue pre-deal research reports regarding EGCs. Section 2(a)(3) of the Securities Act generally prohibits the publication of pre-deal research reports because they would be considered an unauthorized offer for sale or offer to sell a security (i.e., an improper prospectus). However, Section 105(a) of the JOBS Act provides that a research report regarding an EGC, which is defined to include both written and oral communications, issued by a broker or dealer prior to pricing an offering will not constitute an offer for sale or an offer to sell securities, even if the broker or dealer is participating or will participate in the registered offering. Thus, pre-deal research on an EGC, including with respect to IPOs, will not constitute an improper prospectus.

Notably, however, the JOBS Act does not prohibit the SEC or a national securities association (i.e., FINRA) from enacting rules regulating or restricting the issuance of EGC research reports prior to pricing.

B. Conflict of Interest Rules

The JOBS Act also removes some of the regulatory restrictions put in place to address potential research analyst conflicts of interest with respect to the coverage of EGCs. Section 105(b) of the Act prohibits the SEC or any national securities association from enacting or maintaining rules which would restrict, based on functional role, who may arrange for communications between a research analyst and a potential investor in connection with the IPO of an EGC. Section 105(b) also prohibits the enactment or maintenance of any rule that would restrict a research analyst from participating in any communication with the management of an EGC that was also attended by investment bankers. The implication of this provision (discussed in more detail below) is that research analysts are now permitted to attend pitches for investment banking work in connection with the IPO of an EGC.

C. Communications with Potential Investors

Section 105(c) of the JOBS Act permits the EGC or any person authorized to act on its behalf to communicate, either orally or in writing, with potential investors that are qualified institutional buyers or

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1 Pre-deal research reports are already used regularly in most of Europe and Asia, where the practice is not to include a rating or price target when issuing the report.
institutional accredited investors in order to gauge interest in a contemplated securities offering, including (but not limited to) an IPO, either before or after the filing of the registration statement. Such communications will not be subject to the “gun-jumping” restrictions found in Section 5(c) of the Securities Act, and, if written, will not be required to conform to the requirements for a Securities Act Section 10 prospectus or a Rule 433 free writing prospectus.

D. Post-IPO Research Reports

Section 105(d) of the JOBS Act prohibits the SEC or any national securities association from enacting or maintaining rules that would prevent the publication or distribution of research reports regarding an EGC after an IPO. It also prohibits the SEC or any national securities association from enacting or maintaining a rule restricting members of a national securities association from making a public appearance concerning the securities of an EGC — i.e., participating in post-deal “road shows.”

III. Changes to the Regulatory Framework and Potential Liability

A. Pre-Deal Research

Under the JOBS Act, the publication of pre-deal research regarding an offering by an EGC is now expressly permitted. Moreover, because the JOBS Act exempts pre-deal research reports concerning EGCs from the definition of an offer for sale or an offer to sell in Sections 2(a)(10) and 5(c) of the Securities Act, pre-deal research reports will be exempt from liability under Section 12(a)(2) of the Securities Act. However, as discussed in greater detail below, such research reports would remain subject to liability under Section 17 of the Securities Act and Section 10(b) of the Exchange Act.

It is important to note that unlike the provisions barring restrictions on post-deal research (found in Section 105(d) of the JOBS Act), there is nothing in the JOBS Act prohibiting the SEC or FINRA from promulgating regulations restricting the dissemination of pre-deal research. It warrants watching to see whether the SEC or FINRA issues guidance or limitations with respect to research coverage initiated prior to pricing an IPO.

B. Existing Anti-Fraud Provisions Continue To Apply

The JOBS Act does not modify the application of the existing anti-fraud provisions of the federal securities laws with respect to EGC research. While the JOBS Act does permit pre-deal research for EGCs, and expressly excludes that research from liability under Section 12(a)(2) of the Securities Act, institutions issuing research still face potential Securities Act Section 17 liability (as to the government) and Exchange Act Section 10(b) liability (both as to the government and to civil plaintiffs) for fraudulent research. Further, pre-deal research regarding an EGC could still form the basis for state-law based fraud claims filed in state court (provided such claims are not brought as class actions).²

Of course, liability under Section 10(b) would only arise if the statements in a research report were knowingly or recklessly false when made. In private litigation arising from the research analyst conflicts issues raised by the federal and state regulatory investigations in 2003, courts have held that, with respect to statements of opinion, a plaintiff must plead and prove that the research analyst “deliberately misrepresented his actual opinions,”³ as expressed in the research report. In other words, a plaintiff would have to prove that the opinions in the report, which include ratings, price targets and other predictions of performance, such as projections, were “both objectively and subjectively false,”⁴ at the time that they were made. This is an extremely high bar to overcome.

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⁴ Id. at 489.
Material factual misstatements or omissions in pre-deal research reports could also give rise to liability under Section 10(b). A plaintiff would be required to show that a report contained objectively false material statements or omitted material facts, and that the research analyst made those statements or omitted those facts with “an intent to deceive, manipulate or defraud.” In the context of a research report, this means that the research report must present a misleading or fraudulent factual picture of the company that is being analyzed.

In addition to showing both falsity and scienter, the private plaintiff would also have to establish loss causation — i.e., that “the subject of the fraudulent statement or omission was the cause of the actual loss suffered” — based on those allegedly fraudulent opinions. In other words, a plaintiff must prove that the misstatements or omissions of fact or false opinions contained in a report concealed some risk that later materialized and played a part in diminishing the market value of the stock recommended by the report. This is another significant bar to liability.

Finally, the procedural protections of the Private Securities Litigation Reform Act of 1995 (“PSLRA”) — such as the heightened pleading standard requiring a plaintiff to allege facts giving rise to a strong inference of scienter and the automatic stay of discovery once a motion to dismiss is filed — would apply to all private litigation concerning pre-deal research reports arising under Section 10(b). Less clear, however, is whether the PSLRA’s safe harbor for forward-looking statements would apply. The safe harbor expressly applies to public companies subject to the Exchange Act’s reporting requirements, and to underwriters, with respect to information provided by or derived from such public companies. An EGC, pre-IPO, does not appear to satisfy this definition, and therefore information provided by or derived from an EGC prior to the IPO may not be protected. Courts have, however, dismissed claims against research analysts based on the common law “bespeaks caution” doctrine, which has characteristics similar to the PSLRA safe harbor. The bespeaks caution doctrine precludes fraud liability for forward-looking statements that are coupled with sufficient “cautionary language or risk disclosures.” Under the doctrine, where a research report “lay[s] out the pros and cons,” of a particular investment with “reasonable cautionary language,” and where the report discloses the potential risks tied to that investment, liability will not attach to forward-looking statements contained in the report. This common law principle is left undisturbed by the JOBS Act (and by the PSLRA).

Thus, the liability standards for pre-deal and post-deal research are the same: where research analysts publish good faith reports accompanied by meaningful cautionary language, it will be difficult for a private plaintiff to successfully prosecute a claim based on the opinions contained in the research report. In other words, those elements of research reports that are considered to be the analyst’s opinion, such as ratings, price targets and projections, will continue to be protected by what is, for practical purposes, an extraordinarily high bar to liability. Statements of fact in a pre-deal research report will, as with post-deal research reports, give rise to liability if they are false or misleading and are made with scienter (i.e.,

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6 in re Salomon Analyst Level 3 Litigation, 350 F. Supp. 2d at 489 (quotation omitted).
7 Lentell v. Merrill Lynch, 396 F.3d 161, 175 (2d Cir. 2005).
8 Id. at 177.
10 Id. at 467.
11 Id. at 468.
12 See, e.g., In re Salomon Analyst Metromedia Litigation, 373 F. Supp. 2d at 238 (generalized arguments regarding conflicts of interest between the investment banking and research departments of a firm were insufficient to show that the opinions in the relevant research reports did not reflect the analyst’s actual opinion); In re Salomon Analyst Level 3 Litigation, 350 F. Supp. 2d at 493 (‘[T]he worst that the accusations amount to is that [the research analyst] was incompetent, a bad analyst, even careless. It is well established in the Second Circuit that forward-looking recommendations and opinions are not actionable in securities fraud merely because they are misguided, imprudent or overly optimistic.’); In re Salomon Analyst AT&T Litigation, 350 F. Supp. 2d at 467 (research analyst’s ‘Buy recommendation could not have been false or misleading unless his actual opinion was otherwise; merely alleging ‘undisclosed motivations,’ that might lead someone to misrepresent his true opinion does not suffice.’) (emphasis in original).
recklessly or intentionally). One issue that bears consideration is that the JOBS Act permits EGCs to initiate the IPO registration process through a confidential submission and review by the SEC, and also permits EGCs to present more limited information in registration statements, including only two years of audited financial statements in their IPO registration statements (rather than three). The availability and reliability of facts about an EGC prior to its public offering (and prior to the public filing of a registration statement) may therefore differ from what is available about a non-EGC company pre-IPO, and research providers may want to consider what (if any) different fact-checking procedures may be necessary as a result.

C. Changes to the Regulatory Framework on Conflicts

1. Section 501 of the Sarbanes-Oxley Act

The JOBS Act does not modify the provisions of Section 501 of the Sarbanes-Oxley Act, and any rules governing research analysts and research reports promulgated under that section that are not directly contradicted by the JOBS Act remain in effect. Further, the JOBS Act (as is discussed above) does not restrict the SEC and FINRA from regulating potential conflicts of interest in the context of pre-deal research reports, and Section 501 of the Sarbanes-Oxley Act expressly permits the SEC (or FINRA) to amend any regulations promulgated under Section 501 “as is necessary for the protection of investors and in the public interest.”

2. Regulation AC

The JOBS Act has no effect on the certification requirements in Regulation AC. Research analysts will still be required to certify that the opinions expressed in their research on EGC-related offerings accurately reflect their personal views, and they will have to disclose whether their compensation is in any way tied to the statements made in their reports.

3. NASD Rule 2711

The JOBS Act expressly abrogates certain restrictions on research analyst conduct contained in NASD Rule 2711, which is an important development for any institution that is not subject to the Research Settlement. Specifically:

- The blackout periods for managers or co-managers of 40 days following IPOs and 10 days following secondary offerings established by Rule 2711(f)(1) are no longer applicable to research reports regarding EGC-related offerings.
- The blackout period for all other participants in an offering of 25 days following IPOs established by Rule 2711(f)(2) is no longer applicable to research reports regarding EGC-related offerings.
- The prohibition found in Rule 2711(c)(4), which precludes research analysts from attending pitch meetings, no longer applies to EGC-related offerings.
- The provisions of Rule 2711(c)(5), which prohibit research analysts from participating in road shows, are now inapplicable to EGC-related offerings.

In an effort to address any remaining uncertainty regarding the interaction between the JOBS Act and Rule 2711, on April 27, 2012, the Securities Industry and Financial Markets Association (“SIFMA”) 

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14 Unlike the express prohibitions against SEC or FINRA rulemaking, the JOBS Act does not address the promulgation of rules by independent exchanges, indicating that NYSE Rule 472, which contains many of the same restrictions as NASD Rule 2711, would be unaffected by the JOBS Act. As a practical matter, however, FINRA now has sole regulatory responsibility for NYSE Rule 472, including all examination, enforcement and surveillance powers. Thus, these provisions of NYSE Rule 472 are effectively rendered moot by the JOBS Act.

15 §§ 105(b), (d).
requested that FINRA clarify that these sections of Rule 2711 were abrogated immediately upon passage of the JOBS Act. SIFMA has requested that FINRA amend Rule 2711 in light of the JOBS Act to reflect which restrictions on research analysts remain in effect. Such clarification would be particularly helpful to eliminate any confusion regarding the impact of the JOBS Act on the ability of research analysts to attend pitch meetings. The reason for the bar against research analyst participation in pitch meetings was the regulators’ concern that they forced research analysts into an inappropriate sales/marketing role, which they viewed as potentially inconsistent with their role in providing their personal views on the company as a potential investment. When this bar was originally proposed, some firms cautioned that it would have a chilling effect on a research analyst’s ability to meet with management of a private company to learn more about that company, and to provide company management with that analyst’s views about the company’s business and industry sector, which the analyst was oftentimes uniquely qualified to do. It may be that, with respect to EGCs, the pendulum has now swung in favor of allowing research analysts to freely communicate with management of EGCs pre-offering, but, given the regulatory attention that has been devoted to this issue, research analysts might be best advised to refrain from attending such meetings until FINRA or the SEC issues definitive guidance. FINRA has not publicly responded to SIFMA’s request as of yet.

4. The Research Analyst Settlement

Significantly, while the JOBS Act prevents the SEC or FINRA from adopting or maintaining certain restrictions on research analysts, the Research Settlement appears to be unaffected by the JOBS Act. As noted above, the Research Settlement is embodied in a federal court judgment, not an SEC or FINRA regulation. Although many of the parallel provisions of NASD Rule 2711 will be abrogated with respect to EGCs, parties to the Research Settlement will not benefit from this regulatory relief, absent some modification of the judgment that embodies the Research Settlement. For example, those research analysts employed by institutions subject to the Research Settlement will still need to have their communications with investment bankers chaperoned by internal legal or compliance staff members, and research analysts may not appear jointly with EGC management or investment banking personnel when communicating with investors regarding an EGC offering. (However, the Research Settlement was amended in March 2010 to remove the ban on research analysts attending pitch meetings, and thus parties to the Research Settlement will benefit from the abrogation of this provision in NASD Rule 2711.)

However, because the Congressional intent as embodied in the JOBS Act expressly contradicts certain provisions of the Research Settlement, a bank subject to the Research Settlement may consider seeking relief from the judgment pursuant to Federal Rule of Civil Procedure 60, and seek to conform the Research Settlement to the new regulatory framework set forth in the JOBS Act. In fact, in addition to its comments to FINRA, SIFMA also requested that the SEC promulgate a rule superseding those provisions of the Research Settlement that conflict with the JOBS Act.

IV. Conclusion

In sum, while the JOBS Act releases some of the restrictions embodied in the existing regulatory scheme with respect to EGCs, providers of research should keep in mind that those restrictions were intended to guard against potential conflicts of interest between research analysts and investment bankers, and should continue to take steps to protect the objectivity and integrity of their research. Moreover, although the JOBS Act breaks new ground by permitting pre-deal research on EGCs, the standards for imposing liability with respect to pre-deal research reports are consistent with traditional standards governing post-deal research reports.

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Authors: 
David B. Hennes
Carmen J. Lawrence

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Contacts:
David B. Hennes
+1.212.859.8355
Partner
David.Hennes@friedfrank.com

Carmen J. Lawrence
+1.212.859.8411
Partner
Carmen.Lawrence@friedfrank.com