Securities Law ADVISORY

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JOBS Act Aims to Jumpstart Capital Formation

Practical Considerations for Issuers and Other Market Participants

The Jumpstart Our Business Startups Act (otherwise known as the JOBS Act), which was signed into law by President Obama on April 5, 2012, contains the most sweeping set of changes to the securities laws governing public and private offerings since the Securities Offering Reform was enacted in 2005. The JOBS Act is intended to lessen in a very broad way the regulatory burdens for emerging growth companies and other issuers seeking to raise capital.

Broadly speaking, the JOBS Act is intended to encourage capital formation in the United States by facilitating:

- initial public offerings by "Emerging Growth Companies," and
- private and small unregistered public offerings by a broader class of issuers.

Among its more significant provisions, the JOBS Act:

- creates a new category of issuer, "emerging growth company" (EGC), with substantially reduced disclosure, auditing and other requirements;
- relaxes restrictions on solicitations for private offerings, permitting advertising and other forms of general solicitation so long as all of the actual purchasers of the securities are either accredited investors (for Regulation D offerings) or qualified institutional buyers (for Rule 144A offerings);
- exempts "crowdfunding" from securities registration requirements, allowing companies to raise relatively small amounts of capital through small investments from a large pool of investors;
- raises from $5 million to $50 million the exemption limit for securities issued in small unregistered public offerings; and
- raises the threshold for the number of shareholders that a company must have to be required to register a class of securities and for banks and bank holding companies to deregister their securities.

Many of the provisions of the JOBS Act instruct the Securities and Exchange Commission (SEC) to adopt implementing rules within 90 days to one year of the date of enactment. Because the SEC has not yet completed the rulemaking required by the Dodd-Frank Act, passed in 2010, it is possible that the SEC may not be able to satisfy this more aggressive timetable.

Emerging Growth Companies

The JOBS Act exempts EGCs from some of the costly requirements of going public and thereafter of being a public company (for up to as long as five years) and eliminates certain other impediments to a successful initial public offering (IPO). By so doing, the JOBS Act is intended to encourage capital formation by making the IPO process more attractive to many companies that may have previously been hesitant to go public. EGC is defined as any company that had total annual gross revenues of less than $1 billion during its last fiscal year. Generally speaking, a company continues to be an EGC until five years have passed since its IPO, the company's total gross annual revenues have reached $1 billion (indexed for inflation), the company has issued more than $1 billion in non-convertible debt in the prior three years, or the company is deemed to be a "large accelerated filer" (meaning, among other things, its public float has reached $700 million).

The substantial regulatory relief offered to EGCs includes the following:

- **EGCs are allowed to "test the waters."** An EGC, along with its authorized persons, including underwriters, is allowed to "test the waters" with qualified institutional buyers (QIBs) and institutional accredited investors before and after the initial filing of a registration statement. This enables an EGC to solicit indications of interest before incurring the substantial costs and burdens of preparing a registration statement and filing it with the SEC. Pre-road show meetings with key institutional investors will likely become a standard part of the IPO process for EGCs.

- **EGCs are provided confidential SEC review of their IPO registration statement.** An EGC is not required to publicly file its IPO registration statement but can instead submit it (as well as amendments to it) to the SEC for review on a confidential basis. This, and the ability to test the waters, permits an EGC to explore conducting an IPO without disclosing sensitive information to the market and enables the EGC to avoid any embarrassment associated with pulling an IPO should the company decide not to go through with it. However, at least 21 days prior to the start of any roadshow, the EGC must publicly file its registration statement and all accompanying amendments.

- **There are fewer restrictions on research reports and research analysts during the EGC IPO process.** Research reports from securities analysts, even those from broker-dealers participating in the IPO of an EGC, are no longer considered "offers" under Section 5 of the Securities Act of 1933. Thus, the JOBS Act permits securities analysts to release research reports about an EGC at any time, both pre-IPO and during the traditional quiet period following an IPO (although there is some reason to believe that analysts may be reluctant, at least initially, to take advantage of this flexibility pre-offering). This is expected to spur an increase in research coverage of newly public companies.

  Also as a result of the JOBS Act, securities analysts are permitted to meet with members of the EGC's management before the EGC files a registration statement and during the post-filing, pre-effective period, even if investment banking personnel and other representatives of the broker-dealer are present and/or coordinate the meetings.

  - These provisions of the JOBS Act require the SEC and the Financial Industry Regulatory Authority (FINRA) to revise some of their rules and interpretations accordingly. Also, although New York Stock Exchange (NYSE) Rule 472, which imposes restrictions on research, is not directly affected by the JOBS Act, the NYSE is likely to amend Rule 472 to conform with FINRA's changes to its research rules.

  - Research analysts still must comply with FINRA rules and interpretations that are not affected by the JOBS Act. For example, research analysts are still prohibited from participating in efforts to obtain investment banking business.

- **EGCs are entitled to substantial relief from financial reporting requirements.** An EGC is required to provide only two years, rather than three years, of audited financial statements and "management's discussion and analysis," and two years, rather than five years, of selected financial data, in its IPO registration statement. An EGC is not required to have its independent accountants audit management's assessment of the EGC's effectiveness of its internal controls, as is required under Sarbanes-Oxley Act (SOX) Section 404(b), although the EGC is still required to establish and maintain internal controls and to file the CEO and CFO SOX Section 302 certifications (which include statements regarding the status of the EGC's internal controls) with its periodic reports. This relief from SOX Section 404(b) is intended to result in significant ongoing savings to EGCs (although companies that qualify as "smaller reporting companies" are already exempt from SOX Section 404 requirements). Additionally, EGCs are not required to comply with new Generally Accepted Accounting Principles (GAAP) pronouncements applicable to public companies until they are also made applicable to private companies. (Often new or revised accounting standards will provide private companies with more lead time for compliance than public companies receive.) EGCs also are not required to comply with any future Public Company Accounting Oversight Board (PCAOB) rules mandating auditor rotation or requiring a supplement to the auditor's report providing additional information about the financial statements and the audit, nor will EGCs be compelled to comply with any other future PCAOB rules unless the SEC has expressly determined that the additional requirements are necessary.

- **EGCs are subject to less burdensome compensation disclosure requirements.** An EGC may use the smaller reporting company standard for compensation disclosures, meaning it must disclose the compensation of only its top three, rather than its top five, executive officers and is not required to provide the "compensation discussion and analysis" section in its IPO registration statement and subsequent periodic reports. An EGC also is not required to provide an analysis of the relationship between executive compensation and company financial performance or a ratio of annual CEO compensation to annual median worker pay.

- **EGCs are exempt from the say-on-pay and golden parachute voting requirements.** This exemption continues to apply to a company for either one or three years after losing its EGC status, depending on how long the company was an EGC.

So, what questions do you have about EGCs?

Q: ***What if an EGC prefers not to use EGC reporting status?***

A: EGC status is optional, for it is anticipated that some investors may expect larger EGCs to "step up" to the more stringent standards applicable to non-EGCs. A company must make a one-time, "all-in" choice when it is first required to file a registration statement or periodic report with the SEC. Companies are not allowed to pick-and-choose between two different sets of requirements.

Q: ***How many companies going public will qualify as an EGC?***

A: Only a few companies going public have annual gross revenues over $1 billion. By way of example, 41 companies went public during the first quarter of 2012, and out of those, only five would <u>not</u> have been covered under the definition of EGC.

Q: ***What if a company that qualifies for EGC status has already filed an IPO registration statement? Can the company still use the rules for EGCs?***

A: Whether such a company can take advantage of the rules for EGCs depends on when the first sale of its common equity securities took place. If a company has filed its IPO registration statement with the SEC but its IPO has not yet priced, or if its IPO was priced after December 8, 2011, then it is able to avail itself of the relaxed requirements applicable to EGCs. If this first sale occurred on or before December 8, 2011, then the company does not qualify as an EGC.

Q: ***What about investment firms subject to the Global Analyst Research Settlement? For example, are their analysts and investment bankers able to jointly communicate with an EGC's management?***

A: The JOBS Act does not address the restrictions of the court-ordered undertakings in the 2003 Global Analyst Research Settlement between the SEC and 12 investment banks. The JOBS Act permits joint analyst/banker communications with an EGC's management for any purpose and without a chaperone. Investment banks subject to the Global Analyst Research Settlement should consult counsel to determine if, and how, they may take advantage of this and other relief afforded to investment banks by the JOBS Act.

Though the above changes took effect immediately upon the JOBS Act's enactment, it is expected that the SEC and FINRA will issue certain implementing rules and interpretive guidance relating to EGCs at some point in the near future. As a result, EGCs may be unable to take full advantage of the JOBS Act's reforms until such rules and guidance are adopted.

Unregistered Offerings

Not all of the sweeping changes in the JOBS Act are reserved for companies qualifying as EGCs. The JOBS Act includes other reforms that are intended to encourage companies to raise capital in private offerings and in small public offerings without triggering registration requirements under the Securities Act of 1933 or the Securities Exchange Act of 1934.

- **Private offering restrictions on general solicitations are relaxed.** Advertising and other forms of general solicitation have until now been permissible only in SEC-registered offerings. The JOBS Act permits widespread advertising and other forms of "general solicitation" in private offerings pursuant to Rule 506 of Regulation D so long as the issuer takes "reasonable steps" to verify that all of the actual purchasers of the securities (not the offerees) are accredited investors. Similarly, for private offerings under Rule 144A, the seller and anyone acting on behalf of the seller must "reasonably believe" the buyer is a QIB. Whether the "reasonable steps" and "reasonably believe" standards will differ in practice is left to the SEC, which must implement these changes within 90 days of enactment of the JOBS Act.

  The JOBS Act also provides that persons who act to bring issuers and potential purchasers together for a Rule 506 offering are not required to register with the SEC as a broker or dealer if certain conditions are satisfied, including that the person may not receive any compensation, or handle any customer funds or securities, in connection with the purchase or sale of the securities.

  Practical consequences:

  - Initial purchasers or placement agents can be named in press releases for private offerings conducted in reliance on Rule 506 of Regulation D or Rule 144A.

  - A private Rule 506 offering could still be integrated with a concurrent public offering, thus requiring registration of the entire offering. In 2007, the SEC provided extremely helpful integration guidance in Securities Act Release No. 8828 (August 3, 2007) that set forth a framework for analyzing potential integration issues in the specific context of concurrent private and public offerings. The SEC explained that the key factor in such an analysis was how the investors in the private offering were solicited. The status of that guidance is now unclear as a result of the JOBS Act.

- The JOBS Act may change market practice for audited financial statements used in private placements and Rule 144A offerings. There has historically been a strong preference (but not a requirement) to include three years of audited financials in private placement and Rule 144A offering memoranda, consistent with the requirement for a registered offering. Because the JOBS Act permits EGCs to provide only two years of audited financial statements in their registration statements, market practice could move to including only two years of audited financial statements in an offering memorandum for a non-EGC issuer that is conducting a private placement or a Rule 144A offering.
- It is important to keep in mind that the issuer and other offering participants remain subject to antifraud liability for the content of any advertising or other general solicitation materials that are used in connection with the offering. This may cause some issuers to continue to observe the current restrictions on publicity, but without the concern that an inadvertent general solicitation would make a private placement unavailable.

- **Crowdfunding exemption is codified.** Crowdfunding, a topic that has been the subject of much discussion, is now expressly exempt from federal and state securities registration requirements by a new Section 4(a)(6) and Section 4A of the Securities Act of 1933. Crowdfunding is a capital raising strategy for private companies, often early stage or small companies, to raise small amounts of money, often via Internet platforms, through pooled, relatively small investments by a potentially large group of investors.

  Under the crowdfunding exemption, a company may sell unregistered securities to the public if the total amount of securities sold by the issuer, including amounts sold pursuant to the crowdfunding exemption during the preceding 12 months, does not exceed $1 million. The maximum amount that an individual in the “crowd” may invest under the crowdfunding exemption in any 12-month period will depend on each individual’s annual income or net worth but can range from $2,000 to $100,000. The issuer is not permitted to advertise the terms of the offering, except for notices that direct potential investors to a broker or funding portal (discussed below). Securities purchased pursuant to crowdfunding are subject to a one-year holding period unless resold to the issuer, to an accredited investor, to a family member or in a registered offering. Any crowdfunding effort will not be integrated into any other means an issuer may use to raise capital.

  Issuers must conduct crowdfunding activities through an SEC-registered broker or a newly created class of SEC-registered “funding portals.” “Funding portal” is defined as a person acting as an intermediary in a crowdfunding transaction between the issuer and the investor that does not, among other things, offer investment advice or recommendations; solicit purchases, sales or offers to buy the securities displayed or referenced on its website or portal; or hold, manage, possess or otherwise handle investor funds or securities.

  Any broker or funding portal in a crowdfunding transaction must:

  - register with the SEC;
  - warn investors as to the risks involved;
  - require each potential investor to answer basic questions demonstrating that such investor understands the risks of the investment, including illiquidity;
  - take measures to reduce risk of fraud, including performing a background check on the issuer’s principals and 20 percent or greater shareholders;

- provide a target offering amount and a deadline to reach that amount and ensure that a third-party custodian holds all investments until the target amount is reached;
- protect the privacy of information collected from prospective investors; and
- not have an interest in the issuer.

In addition, a company raising capital in a crowdfunding transaction must file with the SEC and provide to potential investors fairly detailed information about the issuer and the offering, including the following financial statements: (i) if raising $100,000 or less, a tax return and a financial statement certified by a principal of the company; (ii) if raising up to $500,000, financial statements that are "reviewed" by an independent accountant; and (iii) if raising more than $500,000, audited financial statements.

Furthermore, a company raising capital in a crowdfunding transaction will be required to make an annual filing with the SEC, the contents of which is to be determined by the SEC. Note that in addition to the issuing company, executives and directors will be liable for any material misstatements and omissions made to purchasers of securities issued pursuant to the crowdfunding exemption.

The SEC must issue rules necessary to implement the crowdfunding exemption within 270 days of enactment of the JOBS Act.

Q: Can any company use the crowdfunding exemption?

A: No. The crowdfunding exemption cannot be used by a public company nor an investment company (as defined by the Investment Company Act of 1940) and is only available to companies organized under the laws of a U.S. state or territory or the District of Columbia. Also, there is a "bad boy" disqualification for issuers who have been convicted of certain types of wrongdoing or who have filed a registration statement that is the subject of certain SEC proceedings or examinations or has been the subject of a stop order.

- **Exemption limit for small public offerings has been raised.** The JOBS Act requires the SEC to amend Regulation A, or to adopt a new exemption from registration similar to Regulation A, for public offerings by U.S. and Canadian non-reporting companies of up to $50 million of debt, equity or convertible debt securities in any 12-month period, up from the current Regulation A limit of $5 million in any 12-month period. Securities sold pursuant to this exemption are not restricted and therefore can be immediately resold. While issuers for such offerings may "test the waters" before filing any offering statement with the SEC, issuers are required to file audited financial statements annually with the SEC and may be subject to additional conditions that the SEC has broad discretion to impose. (Such additional conditions could include, for example, a requirement to file an offering statement with the SEC and deliver copies of it to prospective investors and a requirement to file periodic reports with the SEC.)

The JOBS Act does not specify a date by which the SEC must issue rules to implement the exemption, though it does specify that the SEC has 270 days to establish disqualification provisions.

Because many IPOs in the United States raise less than $50 million, this expanded exemption in the JOBS Act may significantly impact the number of smaller IPOs in the United States. However, the extent of such an impact will depend heavily on the up-front and on-going obligations that the SEC chooses to impose on companies that use the exemption.

Shareholder Threshold for Registration

- **Threshold for the required registration of a class of securities of a company has been raised.** The JOBS Act requires an issuer to register a class of its equity securities under the Securities Exchange Act of 1934 within 120 days after the end of its fiscal year if, on the last day of that fiscal year, it had total assets in excess of $10 million and a class of its securities is held of record by either 2,000 persons or 500 persons who are not accredited investors. (Previously, the threshold was $10 million in assets and at least 500 shareholders of record.) This increased threshold excludes shareholders who received their securities pursuant to an employee compensation plan as well as any securities received as part of the new crowdfunding exemption or the expanded Regulation A exemption. The JOBS Act does not specify a date by which the SEC must adopt implementing rules.

  Questions left for the SEC to address include how an issuer is to know whether an investor was, at the time of the person's acquisition of the securities, an accredited investor and whether the person has subsequently lost that status (including due to retirement or some other event). Also left for the SEC to determine is whether subsequent holders of securities that were originally issued pursuant to an employee compensation plan, the crowdfunding exemption or the expanded Regulation A exemption count toward the threshold.

  A similar change raises the shareholder cap applicable to banks and bank holding companies to 2,000 without further limiting the number of shareholders of record that are not accredited investors and also raises the threshold for de-registration by a bank or bank holding company from 300 shareholders of record to 1,200. The SEC must issue rules implementing these provisions applicable to banks and bank holding companies within one year after the enactment of the JOBS Act.

  These changes provide issuers, including large issuers that are not EGCs, with the flexibility to stay private for a much longer period of time and generate a much larger shareholder base before conducting an IPO. (Critics have pointed out that the ironic result may be that a JOBS Act meant to spur IPOs may actually deter them.) It is unclear what effect this change will have on the secondary trading market for shares of such large privately held companies. Because the shares of these companies are not registered under the Securities Exchange Act of 1934 and these companies therefore are not subject to the fulsome reporting requirements of the Securities Exchange Act of 1934, the securities cannot trade on established, recognized exchanges like the NYSE or Nasdaq. This will possibly lead to a class of companies with perhaps thousands of beneficial owners whose securities trade on private trading networks like SecondMarket or on non-U.S. exchanges like the London Stock Exchange's Alternative Investment Market (AIM).

  Q: ***Are shareholders who hold their securities in "street name" counted as shareholders of record?***

  A: No. The SEC's rules regarding shareholders of record remain unchanged. Beneficial holders who hold securities through brokerage firms, banks, etc. continue to not be counted as shareholders of record.

  Q: ***Given the new requirements for registration, can a company that is not a bank or a bank holding company and has less than 2,000 shareholders of record and 500 shareholders of record who are not accredited investors deregister?***

  A: Probably not. The JOBS Act expressly provided the threshold at which a bank or bank holding company could deregister (see above), thus Congress presumably intended to leave in place the 300 shareholder standard for delisting required by Rule 12g-4 for all other issuers.

Further SEC Studies

The JOBS Act requires the SEC to undertake several studies, such as the advisability of trading and quoting securities in one penny increments ("tick size" or "decimalization"), particularly for EGCs; a comprehensive analysis of Regulation S-K in order to recommend changes to facilitate the registration and reporting process for EGCs; a study of the impact of blue sky laws on Regulation A offerings; and a study of the SEC's enforcement authority under Rule 12g5-1(b)(3) to prevent circumvention of the record shareholder threshold condition for required registration of a class of securities under the Securities Exchange Act of 1934.

Conclusion

The JOBS Act is intended primarily to increase the number of IPOs and other capital formation transactions by smaller companies in the United States by relaxing regulatory requirements in order to decrease the costs and burdens of capital formation. In order to lessen the costs and burdens, however, the JOBS Act removes or weakens existing requirements and prohibitions intended to protect investors and the integrity of the capital markets. Whether or not those requirements and prohibitions were merely impediments to the formation of capital or were necessary to the protection of investors remains to be seen.

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