March 27, 2012

Congress Passes JOBS Bill for Emerging Growth Companies

Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act") today with the stated intention of making it easier for emerging growth companies to raise capital and, as a result, to increase employment. President Obama is expected to sign the bill promptly. The JOBS Act sets forth six legislative initiatives. Among other things, the JOBS Act will allow emerging companies to raise funds from a broad base of small investors through general advertising, both online and offline ("crowdfunding"). The JOBS Act is intended to simplify the registration process for securities of smaller companies and otherwise improve access to public capital markets for emerging growth companies. A brief summary of each initiative follows. We expect to provide a more in-depth analysis of each initiative as rules are proposed and adopted. **Title I -- IPO "On-Ramp"** Title I is designed to reduce the costs of going public for emerging growth companies by phasing in certain requirements for new public companies over a five-year period. The premise of Title I is that a ramp-up of reporting and compliance requirements will impose fewer expenses on new public companies, thereby encouraging more U.S. companies to go public, leading in turn to more initial public offerings in the U.S. and thus creating more jobs in the U.S. The bill creates a new category of issuer known as the "emerging growth company" ("EGC"). An EGC is defined as an issuer that: (i) has total annual revenues of less than $1 billion, (ii) has issued less than $1 billion in nonconvertible debt in the previous three-year period, (iii) is not a "large accelerated filer" (i.e., has a total public float of less than $700 million), (iv) if its securities are registered under the Securities Act of 1933 ("Securities Act"), first sold securities pursuant to a Securities Act registration statement in the last five years, and (v) had its first sale of common equity pursuant to an effective registration statement after December 8, 2011. Title I would relax or eliminate various requirements for EGCs under the Securities Exchange Act of 1934 ("Exchange Act"), including:

- the requirement for a shareholder "say on pay" vote;
- certain executive compensation disclosure items, including;
  - the disclosure of golden parachute compensation arrangements,
  - the relationship between executive compensation actually paid and the financial performance of the issuer,
  - the relationship between the CEO's pay and the median pay of all its employees, and
  - the internal controls required by Section 404(b) of the Sarbanes-Oxley Act of 2002.

An EGC could also make a confidential filing of a draft registration statement prior to an "official" filing with the SEC. A registration statement would require only two years of audited financial statements. In addition, a broker-dealer may issue research reports about an EGC and its securities without the reports being deemed "offers for sale" of the securities, even if the broker-dealer participates in the registered offering of the securities of the EGC. Companies that qualify as EGCs will have to weigh the advantages of somewhat reduced disclosure obligations against investor and analyst expectations, especially as it relates to Sarbanes-Oxley Section 404 compliance. Furthermore, the use of analyst research reports may be subject to other limitations, most notably the 2003 agreement involving the New York Attorney General and major investment banks that prohibit the use of such reports in securities offerings. **Title II -- Access to Capital for Job Creators** Under Title II, Rule 506 of Regulation D would be amended to allow general advertising and solicitation in the sale of unregistered securities, provided all purchasers are "accredited investors." The result of this change would allow:

- The use of social media and the Internet to identify wealthy investors who may wish to invest in emerging companies.
- In-person seminars and webinars to sell securities to accredited investors.

However, issuers must take reasonable steps to verify that the purchasers are accredited investors. Issuers cannot just rely on self-certification. The SEC may adopt rules to guide issuers about how to determine whether purchasers qualify as accredited investors. Rule 144A of the Securities Act would also be amended to allow *offers* to nonqualified institutional buyers, including by means of general advertising, provided securities are *sold* only to a person that the issuer reasonably believes is a qualified institutional buyer. Individuals who organize forums or websites to bring together investors and companies seeking investors will not be required to register as brokers or dealers under certain circumstances. This new exemption would apply to those who organize forums in person or online. The SEC is required to release the new regulations under the JOBS Act within 90 days of enactment.

Title III -- Entrepreneur Access to Capital

A new crowdfunding exemption will allow companies to raise small amounts of money from a large number of investors. This is the first time the federal securities laws have permitted this kind of broad-based capital raise from small investors. Emerging companies may be able to use the Internet to raise start-up capital under this exemption.

- Crowdfunding is available to issuers raising no more than $1 million in any 12-month period. This amount is subject to increase for inflation.
- Investors are limited in the total amount they can invest in any crowdfund offerings during a 12-month period, as follows:
  - The greater of $2,000 or five percent of the investor's annual income or net worth, if either annual income or net worth is less than $100,000.
  - Ten percent of annual income or net worth (not to exceed $100,000), if either annual income or net worth is equal to or greater than $100,000.
- Sales must be made through a broker or "funding portal" that is registered with the SEC. The "funding portal" is a new concept, referencing individuals acting as intermediaries that do not offer advice, solicit sales of securities, or compensate employees or agents based on sales.
  - Intermediaries would be required to reduce the risk of fraud by performing background checks on officers, directors and significant stockholders of issuers. The SEC may adopt additional antifraud rules.
  - Intermediaries must also require investors to complete questionnaires demonstrating their knowledge of the speculative risk of investment in emerging companies, including lack of liquidity.
  - Intermediaries must ensure investor funds are not provided to the issuer until a previously established target offering amount is reached. The funds would be returned to the investors if the target was not reached.
- Issuers must provide comparable warnings to investors and make information disclosure filings with the SEC.
- A one-year holding period would generally be required for securities purchased in a crowdfund offering.
- The SEC may adopt rules to disqualify certain issuers and intermediaries from participating in crowdfund offerings.

- Stockholders who purchase shares in crowdfund offerings will not be counted toward the threshold number of stockholders necessary for registration under the Exchange Act.
- Securities sold in crowdfund offerings will be "covered securities," exempt from state registration, documentation and offering requirements.

Title IV -- Regulation A SEC Regulation A currently exempts certain small securities offerings from the SEC registration requirements. While the exemption is not often used, the JOBS Act would increase its availability. Title IV requires the SEC to increase the Regulation A exemption from $5 million to $50 million in offered securities. In addition, the JOBS Act directs the SEC to create rules to mandate that the securities sold under Regulation A:

- may be offered and sold publicly, and
- are not "restricted securities."

This exemption pertains only to equity securities, debt securities, and debt securities convertible or exchangeable to equity interests (including guarantees of such securities). Issuers relying on Regulation A would be permitted to solicit interest in the offering prior to filing an offering statement with the SEC. However, civil liability under Securities Act Section 12(a)(2) will apply, and issuers will be required to file audited financial statements with the SEC annually. Title IV also grants the SEC the authority to determine terms, conditions or requirements that may be in the public interest and for the protection of investors. Potential SEC rules may require the issuer to prepare and electronically file with the SEC the offering statement and audited financial statements, as well as periodic disclosure regarding the issuer, its business operations, its financial condition, its corporate governance principles, its use of investor funds and other appropriate matters. The SEC may promulgate disqualification provisions, similar to those in Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, under which the Regulation A exemption will not be available. Going forward, the SEC must review the offering amount limitation every two years and increase the limitation from $50 million as appropriate. **Titles V and VI -- Raising the Bar for Registration** Section 12(g) of the Exchange Act currently requires that an issuer register with the SEC once its securities are held by 500 or more record holders and it has assets of more than $10 million. Title V of the JOBS Act increases the threshold for Exchange Act registration to 2,000 record holders or 500 record holders who are not accredited investors. This significant increase in the registration threshold under Section 12(g) will be especially helpful for startup companies funded by "angel" investors and venture capitalists. Only holders "of record" are counted to determine Exchange Act registration requirements. Under the JOBS Act, shares held by persons who received the securities pursuant to stock option plans or other employee compensation plans exempted from Section 5 of the Securities Act would not be considered "held of record." The JOBS Act requires the SEC to revise the definition of "held of record" accordingly. The JOBS Act does not require an issuer to count beneficial holders. Title VI also includes special rules for banks and bank holding companies, which are typically funded in their early stages by a higher number of investors who are not accredited. Title VI increases the registration threshold from 500 to 2,000 record holders, regardless of whether such investors are accredited. While Section 12(g) of the Exchange Act continues to allow most companies to deregister when they have fewer than 300 holders of record, Title VI allows banks and bank holding companies to deregister once they have fewer than 1,200 holders of record. The JOBS Act also instructs the SEC to consider its authority to enforce Rule 12g5-1, if the SEC determines new enforcement tools are required to enforce the anti-evasion provision in subsection (b)(3) of the rule. Rule 12g5-1 sets forth the criteria for determining holders "of record," while subsection (b)(3) requires that issuers treat beneficial owners as holders of record if it is known that such beneficial owners are trying to circumvent provisions of Section 12(g) or 15(d) of the Securities Act. Title VI requires that the SEC issue final regulations that impact banks and bank holding companies within one year of the bill's enactment. **Conclusion** The JOBS Act has been passed with bipartisan support to increase the ability of smaller companies to raise capital and hire more employees. Our lawyers have decades of experience advising emerging companies on compliance with federal and state securities laws and the process of raising capital in public and private markets. We would be pleased to advise emerging growth companies on the application of the JOBS Act to their businesses.