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JOBS Act Adopts Reforms

On April 5, 2012, the Jumpstart Our Business Startups Act (the JOBS Act) was signed into law. The purpose of the JOBS Act is to make it easier for companies to access capital in both public and private offerings of securities, and thereby to support economic growth. Key provisions of the JOBS Act ease the IPO process and reduce the compliance burdens as a public company for a new category of "emerging growth companies," add or amend exemptions to registration under the Securities Act of 1933, and change the thresholds for a company to become subject to the reporting requirements of the Securities Exchange Act of 1934. The provisions regarding emerging growth companies take effect immediately upon enactment. The other provisions, including those relating to capital access in private placements, generally will require SEC rulemaking to become effective.

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Emerging Growth Companies

The JOBS Act creates a new category of public companies called "emerging growth companies." An emerging growth company is an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year other than an issuer whose first sale of its equity securities pursuant to an effective registration statement occurred on or before December 8, 2011. An issuer that is an emerging growth company will continue to have that status until the earliest of (1) the last day of the fiscal year of the issuer in which the issuer has total gross revenues of $1 billion or more, (2) the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities pursuant to an effective registration statement, (3) the date on which the issuer has, during the previous three-year period, issued more than $1 million in nonconvertible debt, or (4) the date on which the issuer is deemed to be a "large accelerated filer" (which generally is a company that has been subject to SEC reporting requirements for at least a year and has a public float of $700 million or more). The SEC is required to index the $1 billion gross revenue threshold every five years for inflation.

The JOBS Act creates two main benefits for emerging growth companies: Reforms of the IPO process and reduced ongoing compliance requirements as a public company. These are generally referred to as the "IPO on-ramp" provisions, and in many cases limit or eliminate the application to emerging growth companies of some of the compliance requirements added by the Sarbanes-Oxley Act of 2002

and the Dodd-Frank Act of 2010.

IPO Process Reforms for Emerging Growth Companies

Two Years of Financial Information. The registration statement for an IPO of an emerging growth company will only need to include two years of audited financial statements (rather than three years) and two years of selected financial data (rather than five years). Subsequent reports and registration statements will not need to present selected financial data for any period prior to the earliest audited period included in the IPO registration statement.

Confidential Review of IPO Registration Statement. An emerging growth company is entitled to confidential review by the SEC staff of the registration statement for its IPO, although the initial submission and all amendments would need to be publicly filed with the SEC not later than 21 days before the date on which the company conducts a road show.

Communications with Institutional Investors. An emerging growth company or any person authorized to act on its behalf may engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors to determine whether such investors might have an interest in a contemplated securities offering. Such communications may occur prior to or following the filing of a registration statement with respect to such securities.

Analyst Research. The JOBS Act includes a number of provisions to reduce limitations on communications by analysts regarding an emerging growth company that is in registration.

- The publication or distribution by a broker or dealer of a research report about an emerging growth company that is the subject of a proposed or pending registration statement for an offering of equity securities will be deemed not to constitute an offer to sell a security even if the broker or dealer will participate in the registered offering.
- Analyst conflict of interest rules under Section 501 of the Sarbanes-Oxley Act are amended to make it easier for analysts to communicate with emerging growth companies by removing restrictions on who may arrange for communications between analysts and investors, and to permit analysts to

participate in communications with an emerging growth company's management together with other representatives of a broker or dealer.

- The JOBS Act relaxes rules limiting the ability of a broker or dealer to publish reports about an emerging growth company during certain lock-up periods after an IPO.

Reduced Ongoing Compliance Burdens for Emerging Growth Companies

Internal Control Audit. An emerging growth company is exempt from the requirement that its auditors attest as to the effectiveness of internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act. Management would still be required to provide its report on the effectiveness of internal control over financial reporting.

Public Company Accounting Standards. An emerging growth company will not be required to comply with any new or revised accounting standard until the date that such standard applies to a company that is not an issuer subject to SEC reporting requirements.

Auditor Rules. An emerging growth company will not need to comply with any rules that may be adopted requiring mandatory audit firm rotation or an auditor discussion and analysis regarding the audit and the financial statements of the company.

Say-on-Pay. An emerging growth company will not be required to hold a shareholder advisory vote on executive compensation, including golden parachute compensation. Once a company ceases to qualify as an emerging growth company, it will need to hold a say-on-pay vote (1) not later than three years after the date of its IPO if the company ceases to be an emerging growth company less than two years after its IPO or (2) for any other company, one year after it ceases to be an emerging growth company.

Executive Compensation Disclosure. An emerging growth company will not need to disclose a comparison of executive compensation to company performance or a ratio of the total compensation of the chief executive officer to the median total compensation of other employees, both of which are disclosure requirements added by the Dodd-Frank Act and still waiting for SEC rulemaking to implement. In addition, an emerging growth company may comply with the

executive compensation disclosure requirements of Item 402 of Regulation S-K by disclosing the same information required by an issuer with a public float of less than $75,000,000 (a smaller reporting company) that requires disclosure about fewer executive officers for fewer years and allows a company to exclude certain compensation disclosure, including, most significantly, a compensation discussion and analysis.

Ala Carte Compliance. An emerging growth company may elect to forego any of the exemptions and instead comply with the requirements that apply to an issuer that is not an emerging growth company. However, with respect to the provision regarding new or revised accounting standards, if an emerging growth company elects to comply with any new or revised accounting standard that would otherwise not apply to it under the exemption in the JOBS Act, the company must comply with all such standards.

Capital Access Reforms for Exempt Offerings

General Solicitation Permitted in Regulation D and Rule 144A Offerings. The JOBS Act requires SEC to adopt rules eliminating the prohibition on general solicitation and general advertising in Regulation D for offers and sales of securities pursuant to Rule 506 as long as all purchasers of the securities are accredited investors. Such rules must require the issuer to take reasonable steps to verify that the purchasers are accredited investors. The SEC is directed to adopt such rules within 90 days after the date of enactment of the JOBS Act. This provision has the potential to greatly facilitate capital-raising by private companies. The SEC's interpretation of the prohibition on general solicitation and general advertising to require a substantive pre-existing relationship with each person who receives an offer can make it very difficult for an early stage company to properly identify qualified investors. Without those restrictions, a company can broadly disseminate communications regarding an offering and leverage networks of potential investors. The usefulness of this reform may depend on the steps the SEC requires to verify the accredited investor status of accredited investors. In addition, this provision of the JOBS Act seems to require that each purchaser must actually be an accredited investor regardless of the steps taken to verify accredited investor status or the reasonableness of the issuer's belief of accredited investor status. By contrast, Rule 506 currently permits an issuer to rely on a reasonable belief of accredited investor status, as does the JOBS Act with respect to Rule 144A addressed in the next paragraph. Hopefully, the SEC rulemaking will clarify this point.

The JOBS Act also requires the SEC to adopt rules within 90 days permitting general solicitation and general advertising in connection with sales under Rule 144A as long as the securities are sold only to persons that the seller and any person acting on its behalf reasonably believe is a qualified institutional buyer.

Exemption from Broker-Dealer Registration for Regulation D Offering Platforms. The JOBS Act provides an exemption from broker-dealer registration for platforms that permit participants to offer, sell, purchase, solicit, negotiate or advertise securities in compliance with Rule 506 of Regulation D. The exemption also includes certain "ancillary services," including due diligence services if there is no separate fee for investment advice or recommendations, and the provision of standardized documents for a transaction if participants are not required to use such documents as a condition to use the service. In order to qualify for the exemption, no compensation must be paid to the exempted person in connection with the purchase or sale of a security, the exempted person must not have any custody of customer funds or securities, and such person must not be subject to a statutory disqualification under Section 3(a)(39) of the Securities Exchange Act of 1934.

Crowdfunding. The addition of an exemption to allow private U.S. companies to raise capital through "crowdfunding" has probably received as much attention as any provision of the JOBS Act. The basic idea behind crowdfunding is the use of the internet, social media or other means of general solicitation to raise a relatively small amount per investor from a large number of investors who may not be accredited investors. The crowdfunding provision in the JOBS Act reflects this basic idea, but includes a number of protections for investors that may reduce the attractiveness of crowdfunding for issuers.

The JOBS Act adds a new exemption to Section 4 of the Securities Act which requires that:

- the aggregate amount of all securities sold by an issuer to all investors during the 12-month period preceding the transaction does not exceed $1,000,000 (this appears to cover any sales of securities, potentially including employee compensation transactions);

- the aggregate amount sold to any investor under the exemption by all issuers during the 12-month period preceding the transaction does not exceed (1) the greater of $2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or net worth is less than $100,000; or (2)

10% of the annual income or net worth of the investor, as applicable, up to $100,000, if either the annual income or net worth is $100,000 or more;

- the transaction must be conducted through a broker or funding portal that complies with certain requirements; and
- the issuer must comply with a number of requirements, including providing investors and the broker or funding portal, and filing with the SEC, a fairly extensive disclosure document (including financial statements with varying levels of review depending on the offering size), and annually providing investors, and filing with the SEC, such reports of financial results as the SEC may establish by rule.

The requirements for a broker or funding portal to participate in an exempt crowdfunding transaction include:

- registering with the SEC and FINRA either as a broker or a funding portal;
- providing to investors such disclosures regarding risks and investor education materials as the SEC may determine appropriate and ensuring that each investor reviews the investor education materials, positively affirming that investors understand that they are risking the loss of their entire investment and could bear such loss, and requiring that investors answer questions showing an understanding of risks relating to the investment;
- taking such measures to reduce the risk of fraud with respect to the transaction as the SEC may require (which may include background checks on officers, directors and major shareholders of the issuer);
- implementing procedures to ensure that the issuer raises its target capital amount, that no investor exceeds the investment limits in the exemption and that the privacy of information collected from investors is protected; and
- prohibiting the broker or funding portal's directors, officers or partners from having any financial interest in an issuer using its services.

Investors in an offering under the crowdfunding exemption will have a private right of action against an issuer and its directors, principal executive officer, principal financial officer and principal accounting officer if the disclosure in connection with the offering contains material misstatements or omissions. The defendants would have the burden to show that they did not know and, in the

exercise of reasonable care, could not have known, of the misstatements or omissions.

Sales of securities purchased under the crowdfunding exemption would be prohibited for one year, except for transfers (1) to the issuer, (2) pursuant to a registered offering, (3) to an accredited investor, or (4) to certain family members or in connection with the death or divorce of the purchaser or similar circumstances at the discretion of the SEC.

Securities sold under the crowdfunding exemption would be "covered securities" under Section 18(b)(4) of the Securities Act which would not be subject to state registration requirements. The SEC has 270 days from the date of enactment of the JOBS Act to adopt rules implementing the crowdfunding exemption, which will address a number of points left open for SEC rulemaking.

New Exemption for Public Offerings up to $50 Million. The JOBS Act amends Section 3(b) of the Securities Act to direct the SEC to adopt a new exemption from registration of offerings up to $50,000,000. The new exemption is similar to existing (and rarely used) Regulation A, which has a cap of $5,000,000. It still requires the filing with the SEC of the offering documents and adds additional requirements, including audited financial statements, liability under Section 12(a)(2) of the Securities Exchange Act of 1934 for material misstatements or omissions, and authority for the SEC tor require additional post-offering public disclosures. There is no deadline for SEC rulemaking. It remains to be seen if an offering under this exemption will be attractive enough to be an alternative to either a private placement under Rule 506 (particularly with a general solicitation now permitted) or a conventional IPO.

Shareholder Cap for Exchange Act Registration

The JOBS Act increases the threshold for the requirement to register under Section 12(g) of the Securities Exchange Act of 1934 from 500 "holders to record" to either (1) 2,000 holders of record or (2) 500 holders of record who are not accredited investors. For banks or bank holding companies, the threshold is only 2,000 holders of record. The JOBS Act also amended Section 12(g) to increase the total asset threshold from $1,000,000 to $10,0000,000. However, since the SEC has previously adopted a $10,000,000 asset threshold by rule, the asset threshold will essentially remain the same.

In addition, persons who hold securities pursuant to an employee compensation

plan or who received securities pursuant to the crowdfunding exemption are not counted towards the threshold for holders of record.

For banks and bank holding companies, the floor for the number of holders of record that allows the issuer to terminate registration under Section 12(g) is increased from 300 to 1,200.