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Client Alert

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President Obama Signs Jobs Act Into Law

On April 5, 2012, President Obama signed H.R. 3606, the Jumpstart Our Business Startups (JOBS) Act (the "Act"), into law. The Act is intended to help smaller companies access the U.S. capital markets by relaxing certain regulatory compliance and disclosure requirements and easing the capital formation process for private companies and private investment funds. A copy of the Act is available here.

The Act:

- Relaxes certain regulatory compliance and disclosure requirements for a new category of "emerging growth company" having less than $1 billion of annual gross revenues;
- Permits general solicitation and advertising for Rule 506 offerings to accredited investors and Rule 144A offerings to qualified institutional buyers;
- Creates a new registration exemption for sales of securities through so-called "crowdfunding;"
- Authorizes a new simplified public offering exemption for offerings of less than $50 million per year; and
- Increases the thresholds on the number of shareholders of record before an issuer is required to become a reporting public company.

Relaxed Regulation for New Emerging Growth Companies

The Act amends the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to create a new category of issuer referred to as an "emerging growth company." An "emerging growth company" is defined as an issuer with total annual gross revenues of less than $1 billion during its most recent fiscal year. The Act specifically excludes from this category an issuer whose first sale of common equity securities pursuant to an effective registration statement under the Securities Act occurred on or before December 8, 2011.

An emerging growth company maintains this status until the earliest of (1) the last day of the fiscal year in which the issuer had $1 billion in annual gross revenues or more, (2) the last day of the fiscal year following the fifth anniversary of the issuer's initial public offering of common equity securities, (3) the date on which the issuer has issued more than $1 billion in non-convertible debt during the previous three-year period or (4) the date when the issuer is deemed to be a "large accelerated filer," as defined in Exchange Act Rule 12b-2.

The Act provides for exemption from or scaled regulation to be applied to the emerging growth company for up to five years following its IPO. An emerging growth company is exempt from compliance with registered public accounting firm attestation rules under Section 404(b) of the Sarbanes-Oxley Act relating to the company's internal control over financial reporting. The Act also exempts such company from the rules that the Public Company Accounting Oversight Board may adopt relating to mandatory audit firm rotation and rules requiring auditors to provide additional information about an audit or the financial statements of the company. In addition, the Act exempts emerging growth companies from the following requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act:

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- shareholder voting on executive compensation (“say-on-pay”);
- shareholder voting on frequency of say-on-pay votes;
- disclosure of the ratio of the compensation of the CEO to the median of the annual total compensation of all employees of the company;
- disclosure of the relationship between executive compensation and the financial performance of the company; and
- proxy statement disclosure of and separate shareholder voting on executive compensation in connection with an acquisition, merger or sale of all or substantially all of the assets of the company.

The Act allows for scaled disclosure requirements of executive compensation that currently apply to smaller reporting companies (those having a public float of less than $75 million), as well as two instead of three years of audited financial statements, selected financial data and related management’s discussion and analysis of financial condition and results of operations. The Act provides that an emerging growth company is subject to the longer phase-in periods that apply to private companies for any new or revised financial accounting standards.

With respect to registration of securities under the Securities Act, the Act makes the following changes for emerging growth companies:

- permits greater freedom of communication between the company and securities analysts and between securities analysts and potential investors in connection with the company’s IPO;
- allows for publication of research reports on the emerging growth company at the time of or following its IPO by brokers or dealers participating in the offering;
- permits the company to communicate with potential qualified institutional buyers or institutional accredited investors prior to or after the filing of a registration statement to determine their interest in the contemplated securities offering; and
- provides for pre-filing confidential review of draft registration statements by the Securities and Exchange Commission (the “SEC”).

An emerging growth company may choose to forgo the exemptions above and instead comply with the requirements that apply to other issuers. However, an emerging growth company must choose whether it will avail itself of the longer phase-in periods that apply to private companies for any new or revised financial accounting standards at the time it is first required to file a registration statement or other report with the SEC. In addition, an emerging growth company is not permitted to choose an “à la carte” approach to the requirements: if it chooses to comply with the non-emerging growth company requirements, it must comply with all such requirements.

These provisions of the Act will take effect upon signing into law by President Obama; however, a number of existing rules and regulations previously adopted by the SEC, the Financial Industry Regulatory Authority (FINRA), various stock exchanges and other bodies will need to be amended or clarified in light of the changes made by the Act.

General Solicitation and Advertising for Rule 506 and Rule 144A Offerings

The Act will significantly impact the process for private offerings under Regulation D of the Securities Act. The Act requires the SEC to revise its rules, within 90 days of enactment, to remove the prohibition against general solicitation and general advertising in private offerings under Rule 506 of Regulation D, provided that all purchasers of the securities are accredited investors. The new rules must require the issuer to take reasonable steps to verify that purchasers are accredited investors, using methods to be determined by the

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SEC. In addition, the Act amended Section 4 of the Securities Act to provide that offerings made in compliance with Rule 506 will not be deemed public offerings as a result of general advertising or solicitation.

The Act also requires the SEC to revise Rule 144A under the Securities Act, within 90 days of enactment, to provide that securities sold pursuant to that rule may be offered to persons other than qualified institutional buyers, including by way of general solicitation and general advertising, so long as the only purchasers in the offering are persons that the seller has a reasonable belief are qualified institutional buyers.

In addition, the Act exempts entities and individuals from registration as a broker or dealer under the Exchange Act if, in connection with Rule 506 offerings under Regulation D, they (1) maintain a platform or mechanism (whether online, in person or through other means) that brings issuers and investors together for such transactions, (2) co-invest in such securities or (3) provide ancillary services consisting of due diligence services or standardized transaction documents. Such entities or individuals are not eligible for this exemption if they receive transaction-based fees for these activities, possess customer funds or securities or are subject to a "bad actor" disqualification.

Crowdfunding

The Act provides an exemption for "crowdfunding," which generally refers to a method of raising capital in small amounts from a large group of people, usually using the Internet and social media. The Act permits such offerings so long as:

- the aggregate amount sold to all investors by the issuer during the 12-month period preceding the date of such transaction does not exceed $1 million;
- the aggregate amount sold to any investor during any 12-month period preceding the transaction does not exceed: (a) the greater of $2,000 or 5% of the investor's annual income or net worth, if such annual income or net worth is less than $100,000; and (b) 10% of the investor's annual income or net worth, not to exceed a maximum aggregate amount sold of $100,000, if such annual income or net worth is equal to or greater than $100,000;
- the transaction is conducted through an intermediary that complies with certain requirements, including registration with the SEC and other applicable self-regulatory organizations as a broker or "funding portal"[1]; and
- the issuer complies with certain other requirements.

Such an intermediary is required to provide disclosure related to risks as the SEC, by rule, determines appropriate, and to ensure that potential investors understand the associated risks of investing, including by answering questions demonstrating an understanding of the level of risks associated with startups and small issuers. An intermediary must also take certain other measures and satisfy other requirements in connection with a crowdfunding offering to qualify for the exemption. The issuers in crowdfunding transactions must provide investors and the SEC with certain disclosures, including financial statements and a description of the stated purpose and intended use of proceeds of the offering, and must satisfy certain other requirements.

The Act provides that purchasers in a crowdfunding transaction may sue the issuers for rescission if the issuer makes an untrue statement of a material fact or omits to state a material fact. "Issuers" for liability purposes include directors or partners of an issuer, the principal executive officer, principal financial officer, controller and principal accounting officer, as well as any person who offers or sells the subject securities in the offering.

[1] A "funding portal" is defined as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(6) of the Securities Act, that does not offer investment advice or recommendations; solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; hold, manage, possess or otherwise handle investor funds or securities; or engage in such other activities as the SEC, by rule, determines appropriate.

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The Act restricts the resale of securities issued pursuant to the crowdfunding rules. A purchaser may not transfer the securities during the one-year period following the date of purchase except to the issuer, to an accredited investor, as part of a registered offering or to a member of the purchaser's family in connection with the death or divorce of the purchaser.

The crowdfunding provisions do not apply to issuers that are not organized under the laws of a state or territory of the United States or the District of Columbia, are already reporting under the Exchange Act or are investment companies. Issuers will also not be eligible for the exemption if they are subject to a "bad actor" disqualification.

Crowdfunding offerings that qualify for the foregoing exemption from registration under the Securities Act are also exempt from state blue sky regulation relating to registration, documentation and offering requirements, but are not exempt from state investigations and enforcement actions with respect to fraud or deceit or unlawful conduct by a broker, dealer, funding portal or issuer.

Within 270 days of the enactment of the Act, the SEC must issue rules implementing these provisions.

New $50 Million Public Offering Exemption

The Act requires the SEC to adopt rules or regulations to raise the limit for Regulation A offerings from an aggregate of $5 million of securities to be offered and sold publicly by an issuer during any 12-month period to an aggregate of $50 million during any 12-month period, or to create a new exemption from registration similar to Regulation A permitting such increased amounts. Such issuers must file audited financial statements with the SEC annually but could also be required to make periodic disclosures to investors and file periodic reports with the SEC, subject to further SEC rulemaking. The SEC can also require the preparation and filing of an offering statement with the SEC and delivery of the offering statement to prospective investors.

Persons selling securities pursuant to such offerings will be subject to civil liability under Section 12(a)(2) of the Securities Act for an untrue statement of a material fact or an omission of a material fact in connection with the offering. Issuers may solicit interest in an offering, or "test the waters," prior to filing an offering statement, on such terms as the SEC may prescribe. The SEC can also determine in its regulations that the exemption will not be available for certain disqualified issuers.

The Act exempts such offerings from state securities laws when the securities are offered or sold on a national securities exchange or sold to a qualified purchaser, as defined by the SEC.

These provisions are subject to SEC rulemaking, though no timeframe for such rules is provided in the Act. In addition, the Act requires that the SEC review the offering amount limitation not later than two years after the date of enactment of the Act and every two years thereafter, and may increase the $50 million limitation.

Increase in Threshold Number of Holders of Record Before Becoming Reporting Company

The Act also will allow a significant increase in the number of security holders of private companies and certain private investment funds by amending the Exchange Act to increase the threshold for an issuer to become a reporting company under Section 12(g) of the Exchange Act. The registration threshold for the number of holders of a class of equity security (other than an exempt security) has been increased from 500 shareholders of record to either (1) 2,000 shareholders of record or (2) 500 shareholders who are not accredited investors. The Act also creates a new threshold for a bank or bank holding company (as defined in the Bank Holding Company Act of 1956) of 2,000 holders of record, without the additional 500 non-accredited investor threshold. On its face, the Act also increases the threshold in Section 12(g) for the issuer's total assets from $1 million to $10 million, but this change was not substantive because the SEC had previously adopted the $10 million total asset threshold in Exchange Act Rule 12g-1.

Employees receiving securities under employee compensation plans in transactions exempt from registration are excluded from the calculation of holders of record. The Act requires the SEC to adopt rules to revise the

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definition of "held of record" to implement the new exemption for securities received by employees under employee compensation plans. The SEC is also required to adopt safe harbor provisions that issuers can follow when determining whether holders of their securities received the securities pursuant to an employee compensation plan in transactions that were exempt from registration requirements.

The Act also provides that the duty of a bank or bank holding company to file reports under Section 15 of the Exchange Act is automatically suspended if, at the beginning of a fiscal year (other than the year of registration), the number of holders of record for such bank or bank holding company is fewer than 1,200 persons. A bank or bank holding company can also terminate its registration of a class of equity security under Section 12(g) of the Exchange Act at any time the number of holders of record of the securities in that class is fewer than 1,200 persons. The prior minimum of 300 holders of record under Section 12(g) or 15 of the Exchange Act is retained for all other categories of issuers.

The SEC must issue final regulations to implement the foregoing provisions relating to banks and bank holding companies within one year of the enactment of the Act.

Additional Studies Required

The Act requires the following studies:

- The SEC is required to review Regulation S-K to analyze the current registration requirements and determine how such requirements can be updated to modernize and simplify the registration process and reduce associated costs. The SEC must report its findings to Congress within 180 days of enactment of the Act and must include specific recommendations on how to streamline the registration process and make it more efficient and less burdensome for both the SEC and prospective emerging growth companies.

- The Comptroller General must conduct a study on the impact of state blue sky laws on offerings made under Regulation A and must transmit its findings to certain Congressional subcommittees no later than three months from the date of enactment of the Act.

- The SEC is also to examine its authority to enforce the rule defining "held of record" to determine if new tools are needed to enforce certain anti-evasion provisions of such rule and transmit its recommendations to Congress within 120 days of the enactment of the Act.

- The SEC is required to conduct a study on the transition to trading stocks in penny increments and the impact such transition has had on the number of IPOs and the liquidity for small and middle capitalization company securities. The SEC must report its findings to Congress within 90 days of enactment of the Act. The SEC may determine that securities of emerging growth companies should be traded using minimum increments of greater than a penny (but no more than 10 cents) and implement a rule to that effect no later than 180 days after enactment of the Act.

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