Reversing Regulatory Course: JOBS Act Will Ease Capital Formation and Reduce Regulations on New and Private Companies

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On March 27, 2012, the U.S. House of Representatives approved the U.S. Senate version of the Jumpstart Our Business Startups Act or “JOBS Act”. The JOBS Act is expected to be signed by the president in the near future and become law. Whether the JOBS Act stimulates job creation will continue to be a hotly debated issue, but there is little doubt that the JOBS Act makes fundamental changes to the way capital will be raised by a large number of public and private companies. It creates a new paradigm for capital formation for all but the largest companies; one where companies with up to $1 billion in annual revenues will face fewer regulatory requirements when going public, where private offerings can be broadly advertised, and where companies can use the internet and social media to raise up to $1 million every 12 months.

Most significantly, the JOBS Act:

• Creates a new class of company termed an “Emerging Growth Company” with an easier “on ramp” to going public by reducing existing regulatory requirements;

• Relaxes the advertising and solicitation requirements for private offerings of securities;

• Permits “crowdfunding” – the raising of capital from a number of investors via the internet and other social media;

• Increases from $5 million to $50 million the amount of capital that can be raised in a public offering without triggering registration and periodic reporting obligations; and

• Raises the maximum number of shareholders permitted for private companies from 500 to 2,000 (as long as no more than 500 are not accredited).

This alert highlights the most significant reforms of the JOBS Act and how these reforms will transform the way in which capital is raised.

New Company on the Block—“Emerging Growth Company”

Many companies will qualify for Emerging Growth Company status. These companies can raise capital with fewer financial and other disclosures. They will be eligible to provide accredited investors with offering materials before providing them with a prospectus to gauge investor interest. And research analysts will be able to issue research reports on these companies even
though investment bankers in the same firm are underwriting the offering. The JOBS Act provides for a new class of company with annual revenues of up to $1 billion, known as “Emerging Growth Companies” ("EGCs"), with an easier “IPO on-ramp” to going public. In particular, the JOBS Act permits ECGs to conduct an IPO without complying with a number of regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), including audits of internal financial controls and select corporate governance requirements. As long as annual revenues remain under $1 billion, an EGC will remain eligible for these reduced requirements until the end of the fiscal year following the fifth anniversary of its IPO, or until it becomes a "large accelerated filer" with a public float of at least $700 million, or until it issues more than $1 billion in non-convertible debt over a three-year period. There is no grandfathering of EGCs; companies who sold securities pursuant to a registration statement on or before December 8, 2011 cannot claim EGC status. Finally, the SEC is required to conduct a review of Regulation S-K to "modernize and simplify the registration process and reduce the costs and other burdens" for EGCs.

Limited regulation conferred by EGC status includes:

• **Dodd-Frank Exemptions:** Exemptions from currently required non-binding shareholder votes on Say-on-Pay and Say-on-Golden Parachutes and from yet to be proposed rules on CEO-employee pay ratios and pay versus performance disclosures required under Dodd-Frank.

• **Limited Audited Financials:** Only two years of audited financials in IPO registration statements instead of three years.

• **Exemption from new accounting standards:** Exemption from compliance with new or revised financial accounting standards until non-public companies are required to comply with such standards.

• **Exemption under Sarbanes-Oxley 404(b):** Exemption from an independent audit of management’s assessment of a company’s internal controls.

• **Exemption from auditor rotation requirements:** Exemption from auditor rotation requirements that may be imposed by the PCAOB (unless the SEC determines otherwise).

• **Reduced Executive Compensation Disclosure:** May provide the scaled executive compensation disclosure required of smaller reporting companies including an exemption from providing compensation discussion and analysis (CD&A) disclosures.

• **Exemptions from Restrictions on Research Reports:** Research analysts may publish research reports about an EGC, even if investment bankers in the same financial institution are participating in an offering of the EGC’s securities. Investment bankers will no longer be restricted from publishing or distributing research reports or making public appearances in connection with the sale of securities during post-IPO quiet periods. In addition, analysts will no longer be prohibited from participating in communications with management where other investment bankers are present.

• **Expanded Ability to “Test the Waters”:** May gauge investor interest before filing a registration statement by allowing offering and other materials to be provided to potential investors that are institutional accredited investors or qualified institutional buyers before a prospectus is available without filing such materials with the SEC.

• **Ability to Confidentially Submit Draft Registration Statements to the SEC:** May submit to the SEC Staff draft IPO registration statements for review, as long as the initial confidential registration statement and any amendments are publicly filed at least 21 days before a road show.
Advertising and Solicitation—Madison Avenue Meets Accredited Investors

Accredited investors should expect a surge of e-mail and internet offerings and “free lunch” seminars advertising investments in the securities of private companies. Under the JOBS Act, existing advertising and solicitation restrictions will no longer apply to offers or sales of securities made under Rule 506, as long as all of the purchasers are accredited investors. Currently, private offerings made in reliance on Rule 506 of Regulation D, which provides a “safe harbor” for the private offering exemption of Section 4(2) of the Securities Act of 1933 (“Securities Act”), may not be made by means of general advertisement or general solicitation. As a result, issuers generally only market private offerings to persons with whom the issuer has a preexisting relationship. Persons who sell securities under Rule 506 would be exempt from registering as broker-dealers in connection with offering activities on trading platforms that meet certain conditions, including that no compensation is paid in connection with the purchase or sale of securities and that they do not have possession of customer funds or securities in connection with the purchase or sale of securities. The JOBS Act will also eliminate the ban on general solicitation and advertising in connection with private resales of securities under Rule 144A to qualified institutional buyers (“QUIBs”) which are generally large institutional accredited investors.

The JOBS Act requires the SEC to issue rules to relax the advertising and solicitation restrictions within 90 days of passage provided that all purchasers of the securities are accredited investors or QUIBs. The rules must require that the issuer take reasonable steps to verify that purchasers of the securities are accredited investors, or in the case of Rule 144A, the seller or any person acting on behalf of the seller, must reasonably believe that the purchasers are QUIBs. The SEC will determine what constitutes such reasonable steps in its rules.

Crowdfunding

The JOBS Act permits companies to use the internet and social media to sell up to $1 million of securities within any 12-month period to an unlimited number of investors without having to register the offering under the Securities Act. In particular, the JOBS Act creates a new exemption from registration under Section 4 of the Securities Act for these so-called “crowdfunding” initiatives. Investors earning, or with a net worth of, more than $100,000 will be able to invest up to 10% of their annual income or net worth (up to $100,000) and those earning, or with a net worth of, up to $100,000 could invest up to the greater of $2,000 or 5% of their annual income or net worth. Investors will not be able to transfer or resell securities purchased through crowdfunding for one year from their purchase unless they are sold back to the issuer, to an accredited investor, a member of the investor’s family, in connection with the death or divorce of the investor or as part of a registered offering.

At least annually, issuers will be required to file reports with the SEC and provide such reports to investors as determined by the SEC. Prior to a sale, investors must be provided with the final price of the securities and all required disclosures, with a reasonable opportunity to rescind their commitment to purchase. Crowdfunding securities will be treated as “covered securities” meaning that they will be exempted, via pre-emption, from registration under state blue sky laws. Issuers and their directors, partners, principal executive officers, principal financial officer, controller, and any person who offers or sells securities, that make untrue statements or omissions in offering documents or oral communications in connection with the sale of securities will be subject to civil liability.

Intermediary Requirements

Intermediaries that facilitate crowdfunding offerings are subject to a number of requirements and limitations to ameliorate concerns about investor protection through the imposition of quasi-underwriting functions, including:

- **Registration**: Intermediaries must register with the SEC either as a broker-dealer or a “funding portal” that connects companies with investors. Funding portals will be exempt from broker-dealer registration.
Information: Intermediaries must provide investors and the SEC with SEC-mandated information related to risks and other information (summarized below) at least 21 days before the sale of securities.

Investor Outreach and Education: Intermediaries must ensure that investors affirm their understanding that they are risking the loss of their entire investment and can bear such a loss. They must also require investors to answer questions demonstrating an understanding of (1) the level of risk applicable to investment in start-ups or small entities (2) the risk of illiquidity, and (3) other matters to be determined by the SEC.

Anti-Fraud and Threshold Compliance: Intermediaries must take measures to reduce the risk of fraud, including obtaining background checks on directors, officers and 20 percent security holders, ensuring compliance with investment limits, ensuring that proceeds are provided only to the issuer, protecting investor privacy and allowing investors to cancel investments pursuant to SEC rules.

Prohibitions: Intermediaries may not (1) compensate third parties for providing personal identifying information of potential investors, or (2) permit its principals to have a financial interest in an issuer using its services.

Issuer Requirements

To qualify to raise capital through crowdfunding, issuers must file with the SEC and make available certain information to investors, brokers and funding portals, including:

• Identity of Principals: Names of directors, officers and more than 20% equity holders;

• Business Description: Description of the issuer’s business and the anticipated business plan and purpose and intended use of the proceeds of the offering;

• Offering Amount: Target offering amount, deadline to reach the amount, and regular progress updates regarding meeting the target offering amount;

• Price: Public price of the securities or the method for determining the price;

• Financial Statements: Issuers that have raised over $500,000 through crowdfunding in the past 12 months must provide audited financial statements. Issuers that have raised between $100,000 and $500,000, must only provide financial statements that have been reviewed by a independent public accountant and issuers that have raised less than $100,000, need only provide income tax returns for the last fiscal year and CEO-certified financial statements.

• Capital Structure: Description of the ownership and capital structure of the issuer, including terms of the securities being offered and each other class of security of the issuer, how any rights held by the issuer’s principal shareholders could negatively impact investors and how the securities being offered are being valued;

• Risks: Risks related to minority ownership in the issuer, and risks related to corporate actions, including additional issuances of shares, a sale of the issuer or of its assets, and transactions with related parties.

New Frontiers in Capital-Raising—“Small Issue Securities”

Companies will be able to increase their public offerings of securities from $5 million to $50 million without triggering the full disclosure and reporting obligations that normally accompany a public offering of securities. The JOBS Act amends the offering threshold for companies that are exempt from SEC registration under Regulation A under the Securities Act by creating a new exemption from registration and reporting for small issue securities. These offerings
will be subject to state blue sky laws unless they are offered or sold only to qualified purchasers (as determined by the SEC) or sold on a national securities exchange. Such issuers will be required to file annual audited financial statements with the SEC. In addition, the SEC will have the authority to require these issuers to make certain periodic non-financial disclosures available to investors. An issuer of these securities will be able to solicit interest in the offering before it files an offering statement, as determined under SEC rules, and securities issued in these offerings are freely tradable.

**Increased Shareholder Thresholds for Registration**

Companies will be able to increase the number of its shareholders from 500 shareholders of record to 2,000 shareholders of record as long as not more than 500 are not accredited investors before it must register its securities with the SEC and provide investors with periodic reports. Section 12(g) of the Securities Exchange Act of 1934 (“Exchange Act”) requires companies to register with the SEC if they have assets of over $10 million and meet certain shareholder thresholds. Private companies that issue shares directly to shareholders (including employee shareholders) often end up with high numbers of shareholders because these shareholders hold shares directly rather than through financial intermediaries. The JOBS Act increases the current Section 12(g) thresholds and exempts employees who hold securities pursuant to an employee compensation plan and shareholders who hold securities through crowdfunding from counting toward these thresholds.

**Anti-Fraud Rules Will Continue to Apply**

In spite of the changes discussed above, anti-fraud measures, including Exchange Act Rule 10b-5, will continue to apply to the offering and sales of securities. No matter the size of the issuer or the offering, issuers will need to exercise care so as to not make materially misleading statements when engaging in the offer and sale of securities to the public or otherwise.

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