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JOBS Act Will Significantly Relax Restrictions on Capital Raising

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On April 5, 2012, President Obama signed the JOBS Act (Jumpstart Our Business Startups), the culmination of a bipartisan effort by Congress to ease restrictions on capital raising that have affected and guided companies and investors for decades. The bipartisan nature of the process may have resulted in less scrutiny than major securities law revisions often receive; in any case, the SEC is not entirely happy with the results. The law creates a new class of issuer, the "emerging growth company," and treats this class favorably compared to other pre-Act companies that are essentially similar. The Act also changes the ways that new companies will "go public," both in terms of their ability to test the waters and in terms of the ability of research analysts to interact with underwriters and investment bankers. Finally, the Act will permit general solicitation and general advertising in private offerings where such activities were formerly prohibited, and creates new exemptions known as the "crowdfunding" exemption and "Regulation A+".

This alert is a summary of the major features of the JOBS Act. More detailed alerts on parts of the law will be forthcoming in the near future.

What is an Emerging Growth Company?

The Act establishes a new type of issuer, the "Emerging Growth Company" or EGC, which receives new and favorable treatment under the federal securities laws. An EGC is a company (including a foreign company) that meets the following two tests:

- Its initial public offering (IPO) is after December 8, 2011; and
- It has "total annual gross revenues" of less than $1 billion in its most recently completed fiscal year.

An EGC will continue to have that status until:

- The last day of the first fiscal year in which its total annual gross revenues are $1 billion or more;
- The date on which the EGC meets the test for "large accelerated filer" (meaning, a company with an unaffiliated public float in excess of $700 million as of the end of its most recent second fiscal quarter, that has been public for a year and has filed at least one annual report with the SEC);
- The date on which the EGC has "issued" $1 billion or more of non-convertible debt over the three previous years; or
- The last day of the fiscal year following the fifth anniversary of its IPO.

Some Advantages of Going Public as an EGC

There are significant new advantages in the IPO process for EGCs.

Confidential IPO Submissions to the SEC

Prior to the JOBS Act, domestic issuers (and most foreign issuers) wishing to go public had to file their registration statement and preliminary prospectus publicly with the SEC. After the JOBS Act, both domestic and foreign companies may furnish these documents to the SEC in confidential submissions, meaning that the investment community will not know the contents of these submissions (or even that they exist) while they are under review. However, the registration statement and prospectus must be publicly filed at least 21 days before commencing an IPO "roadshow."

Testing the Waters

Equally significantly, EGCs and "persons authorized to act on their behalf" may test the waters both before and after the filing of the registration statement. That is, they may engage in oral and written communications with "qualified institutional buyers" (QIBs) or "accredited investors" (AIs) to determine their "interest in a contemplated securities offering." Significantly, these communications will not have to be filed with the SEC as free writing prospectuses, as previously.

Ending Some Restrictions on Analysts

Eliminating protections that have been in place for some time, research analysts, including those working for the underwriters on an EGC's IPO, may publish research on the IPO both before and after the filing of the registration statement, and after the IPO itself. Research analysts will also be able to participate in meetings with management of an EGC at which investment bankers are present. These changes have raised concerns that analysts may be influenced by their investment banking colleagues seeking to win lucrative business from potentially high flying companies. Another potential conflict of interest is that bankers may use such research to drum up interest in the stock of an EGC, which is often resold to retail investors following an IPO.

Reduced Disclosures for EGCs – The "IPO On-Ramp"

EGCs will be able to use significantly reduced disclosure in the IPO process, including:

- Providing only two (instead of three) years of audited financials and Management's Discussion & Analysis in the IPO registration statement;
- Omitting "Selected Financial Data" for any period prior to the earliest audited period presented in the IPO registration statement (instead of five years).

Once an EGC has gone public, it will be subject to significantly reduced "scaled disclosure" that is now available only to so-called "smaller reporting companies." These include:

- No requirement for Compensation Discussion & Analysis, and the compensation tables will be limited to three (not five) executives and show only two (not three) years of compensation;
- No auditor attestation of internal controls, as required by Sarbanes-Oxley;
- No requirement for "say-on-pay" or "say-on-golden-parachute" shareholder advisory votes (these requirements actually will begin to apply to smaller reporting companies starting in 2013);
- No requirement to disclose the relationship between executive compensation and company performance, or the ratio of CEO pay to median company pay, as required by Dodd-Frank;
- New accounting principles will not apply to EGCs until they apply to all private companies;
- No requirement to comply with any future rules that may call for mandatory audit firm rotation or "auditor discussion & analysis," as proposed in a concept release by the Public Company Accounting Oversight Board.

The JOBS Act effectively creates a new class of public company issuer that will be treated more favorably by regulators than older, smaller companies ("smaller" being a relative term when the ceiling is $1 billion) that are nevertheless good corporate citizens. This disparity is likely to result in a clamor by the non-EGCs for similarly weaker regulation affecting them as well.

Significant Changes to Capital Raising

General Solicitation under Regulation D and Rule 144A

One of the most common methods for raising capital privately utilizes Rule 506 of Regulation D, which is unavailable if there is "general solicitation." The Act gives the SEC 90 days to revise the rules to end the prohibition on general solicitation or general advertising, so long as the actual purchasers are AIs and the issuer takes reasonable steps to verify AI status. There is a similar provision in the Act affecting Rule 144A, which is commonly used in high-yield debt offerings, so long as the actual purchasers are QIBs. Given the "testing the waters" provisions for EGCs, and the ability to engage in general solicitation in Rule 506 private placements, there may be a good deal of confusion about the SEC doctrine known as integration of offerings: when does one offering end, and another commence? This is an issue that has keenly interested the SEC in the past, but it may be very difficult to make that determination now.

New Exemption for "Crowdfunding" Transactions

The Act also gives the SEC 270 days to create a new exemption for issuers that are not public companies, investment companies, or foreign private issuers. Called "crowdfunding," the process would involve the offer and sale of a relatively low dollar amount of securities to a large number of investors. This exemption is evidently intended to reflect social networking phenomena such as Kickstarter. These are the conditions for the exemption:

- The total amount of securities sold in any 12-month period cannot exceed $1 million;
- The amount sold to any investor by an issuer in that 12-month period cannot exceed:
- for investors with annual income or net worth less than $100,000, the greater of $2,000 or 5% of annual income or net worth; or
- for wealthier investors, 10% of the investor's annual income or net worth but not more than $100,000;
- The transaction must be conducted through a registered broker or a registered "funding portal" (a compliant funding portal would not have to register as broker or dealer); and
- The issuer must provide various disclosures and about itself and about risk mitigation.

While it is up to the SEC to provide final rules, the statutory requirements set out in the JOBS Act are not simple and may not be as easy to comply with as the popular press on this subject has suggested.

Regulation A+

For many years, the rules under Regulation A of the Securities Act have authorized an exemption for up to $5 million of securities sold under that Regulation. However, Regulation A is perceived as cumbersome, and Regulation D has been the dominant exemption for private companies raising capital. The JOBS Act directs the SEC to add a new exemption, colloquially referred to in the press as "Regulation A+," but does not specify a time limit for the SEC to do this. Regulation A+ would cover up to $50 million in equity, debt or convertible securities, and issuers would be able to sell unrestricted securities to any potential purchaser by means of a general solicitation. However, there would be an offering document (subject to "prospectus-like" liability), and the issuer may become subject to periodic reporting requirements. Private companies able to raise capital in traditional private placements may be deterred by the reporting requirements. But smaller public companies may wish to utilize Regulation A+ to raise significant debt or equity without going through the full public registration process with the SEC.

Registering and Deregistering as a Public Company

Under a provision of the Securities Exchange Act, it is possible for a company to become "public" (and subject to the SEC's extensive reporting rules) as to a class of its equity securities even if it has never sold securities to the public.

A private company had been required to register under the Exchange Act a class of securities held of record by 500 or more persons once the company also had $10 million of assets. The JOBS Act changes this for companies other than banks and bank holding companies to 2,000 or more record holders OR 500 record holders that are not AIs, retaining the asset test in either case. The Act requires the SEC within 270 days to adopt regulations that exclude from these totals any securities sold under the crowdfunding exemption. Moreover, the Act excludes from the term "held of record" any securities received under an employee compensation plan in exempt transactions, but only while the securities are held by the person who received them under the plan. For banks and bank holding companies, the threshold is 2,000 holders with no limit on the number of investors who are not AIs.

The tracking issues implied by these changes are difficult. Issuers will have to find a way to determine whether their securities are owned by AIs or not. Crowdfunding securities may require a separate CUSIP number. And clearly many employees who receive securities under compensation plans will want to dispose of them to realize their value.

Previously, companies with a class of securities registered under the Exchange Act could deregister when there were fewer than 300 holders of record. For companies other than banks and bank holding companies, the limit is still 300 holders to exit the system, but banks and bank holding companies may deregister when the number of holders of record drops below 1,200.

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