JOBS Act Seeks to Facilitate Growth of Small and Emerging Businesses

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On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act"). The stated purpose of the JOBS Act is "to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." Although provisions of the JOBS Act are generally effective upon enactment, some of the provisions require implementing regulations to be adopted by the Securities and Exchange Commission ("SEC").

As described in more detail below, the JOBS Act creates a new category of issuer, the "emerging growth company," that is subject to less burdensome registration and reporting requirements during and following its initial public offering ("IPO"); relaxes certain restrictions for Regulation D offerings to accredited investors under Rule 506; creates a new transaction exemption under the Securities Act of 1933 (the "Securities Act") for "crowdfunding;" provides the statutory basis for a new limited offering exemption for offerings up to $50 million; increases the period of time that a private company may remain private by increasing the threshold for registration under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") from 500 holders of record, as determined by the issuer at the end of each fiscal year, to either (i) 2,000 holders of record or (ii) 500 holders of record who are not accredited investors; and for banks and bank holding companies, increases the threshold for registration under Section 12(g) of the Exchange Act from 500 holders of record to 2,000 holders of record, and increases the threshold for termination of registration under the Exchange Act from 300 holders of record to 1,200 holders of record.

I. Emerging Growth Companies

Title I of the JOBS Act, which became effective on April 5, 2012, creates a new category of issuer under the Securities Act and the Exchange Act

designated as an "emerging growth company." For these issuers, the SEC registration, reporting and corporate governance requirements are scaled back for up to five years to facilitate the transition from private company to public company through the IPO process. This "on-ramp" is intended to give new public companies time to get up to speed prior to implementation of the full public company reporting and governance requirements.

Qualification. An emerging growth company is defined for purposes of the Securities Act and the Exchange Act as an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. An issuer that is an emerging growth company will continue to be classified as an emerging growth company until the earliest of:

- the last day of the fiscal year of the issuer during which it had total annual gross revenues of $1 billion or more;
- the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equities securities of the issuer pursuant to an effective SEC registration statement under the Securities Act;
- the date on which such issuer has, during the previous three year period, issued more than $1 billion in non-convertible debt; or
- the date on which such issuer is deemed to be a "large accelerated filer," as defined by SEC Rule 12b-2.

An issuer will not be considered an emerging growth company for purposes of the Securities Act and the Exchange Act if the first sale of its common equity securities pursuant to an effective registration statement under the Securities Act occurred on or before December 8, 2011.

With the annual revenue cap set at $1 billion, a significant proportion of new public companies in the future should be eligible for emerging growth company status, an advantage that will not be shared by companies that went public prior to December 8, 2011.

Reduced Disclosure and Corporate Governance Obligations. Emerging growth companies will benefit from relaxed requirements relating to approval and disclosure of executive compensation, presentation of audited financial statements and other financial information, and compliance with certain accounting and audit-related matters. Specifically, an emerging growth company is <u>not</u> required to:

- provide proxy statement disclosure and hold shareholder votes on say-on-pay, say-on-frequency and golden parachute compensation arrangements;
- provide the comprehensive executive compensation disclosures in its annual proxy statement, but is permitted to provide the less burdensome executive compensation information required of "smaller reporting companies," i.e., companies with a public common equity float of less than $75 million (for example, the Compensation Discussion and Analysis (CD&A) is not required, the disclosure in the Summary Compensation Table is reduced and many of the other compensation tables can be eliminated by substituting narrative disclosure);

- comply with the requirement to disclose the relationship of executive pay to performance or the ratio of the annual compensation of the issuer's chief executive officer to the median annual compensation of all other employees of the issuer;
- present more than two years of audited financial statements, selected financial data or management's discussion and analysis (MD&A) in a registration statement for an initial public offering (rather than the usual three years of financial statements and MD&A and five years of selected financial data);
- present selected financial data and MD&A in Exchange Act periodic reports for any period prior to the earliest audited period presented in connection with the issuer's first registration statement that became effective under the Securities Act or Exchange Act;
- comply with any new or revised financial accounting standard until private companies (those that are not "issuers" as defined under the Sarbanes-Oxley Act of 2002) are required to comply with such standards (if such standards apply to private companies);
- comply with the requirement, under Section 404(b) of the Sarbanes-Oxley Act, to obtain an independent auditor attestation report on management's assessment of the effectiveness of the issuer's internal controls (management's annual report on internal controls will still be required);
- comply with any requirement of the Public Company Accounting Oversight Board ("PCAOB") requiring mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements of the company (auditor's discussion and analysis); and
- comply with any additional rules adopted by the PCAOB after the date of enactment of the JOBS Act, unless the SEC determines that the application of such additional requirements is necessary or appropriate in the public interest.

Confidential Submission of Draft IPO Registration Statement. To assist companies engaged in the IPO process, the JOBS Act now permits an emerging growth company to confidentially submit to the SEC a draft registration statement for confidential review by the staff of the SEC prior to public filing. The initial confidential submission and all amendments must be publicly filed with the SEC not later than twenty-one (21) days before the date on which the emerging growth company conducts its road show for the IPO.

Offering Communications. Section 5 of the Securities Act has been revised to provide that an emerging growth company or any person authorized to act on behalf of the company may engage in oral or written communications with potential investors that are "qualified institutional buyers" or institutions that are "accredited investors," as such terms are defined in SEC Rules 144A and 501(a), respectively, to determine whether such investors might have an interest in a contemplated securities offering. These oral or written communications may take place either prior to or following the day that an emerging growth company files its registration statement with the SEC. As a result, emerging growth companies can "test the waters" for a contemplated IPO by contacting institutional investors. The new law does not change the prospectus delivery requirements of Section 5(b)(2) of the Securities Act.

Research Reports and Securities Analyst Communications. The JOBS Act removes or lessens restrictions governing research reports and analyst communications relating to an emerging growth company. Under the new law, the issuance of a research report by a broker or dealer about an emerging growth company in connection with a

proposed IPO (whether or not the registration statement has been filed or is effective) will not constitute an offer for sale under Section 5(c) of the Securities Act, even if the broker or dealer is participating or will participate in the registered public offering. In addition, SEC and Financial Industry Regulatory Authority (FINRA) restrictions are required to be lifted so that brokers or dealers will be permitted to issue research reports or make public appearances with respect to the securities of an emerging growth company immediately following an IPO and around the time that restrictions in lock-up agreements expire. Finally, research analysts now will be permitted to participate in communications with the management of an emerging growth company that are also attended by brokers or dealers who are not analysts. This will facilitate due diligence conducted as part of the IPOs of emerging growth companies. Other restrictions relating to research analysts, such as those relating to conflicts of interest and compensation practices, are not affected by the JOBS Act.

Opt-In Election. An emerging growth company is permitted to forgo the relief provided under the new law and instead comply with the requirements that apply to an issuer that is not an emerging growth company. However, with respect to the extension of time to comply with new or revised financial accounting standards, if an emerging growth company chooses to comply with such standards to the same extent as non-emerging growth companies, the emerging growth company must (i) make its choice at the time the company is first required to file a registration statement, periodic report or other report with the SEC and notify the SEC of such choice, (ii) comply with all such standards to the same extent as other public companies and may not select some standards to comply with and not others, and (iii) continue to comply with such standards for as long as the company remains an emerging growth company.

II. General Solicitation and Advertising Permitted In Certain Private Offerings

Offerings Under Rule 506 of Regulation D. Title II of the JOBS Act requires the SEC to revise its rules relating to Rule 506 offerings under Regulation D within ninety (90) days from the date of enactment. Rule 506 is the SEC's safe harbor for private placements under Section 4(2) of the Securities Act. The revisions will eliminate the long-standing SEC prohibition against general solicitation or general advertising in private offerings made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors (note that the prohibition will still apply to Rule 506 offerings that include non-accredited investors). This means that companies will no longer need to have a "pre-existing relationship" with potential investors. The purpose of the relaxed restriction is to allow businesses in need of capital to reach a wider group of potential investors and therefore have greater access to capital. This should benefit start-ups, entrepreneurs and private companies that seek access to venture, angel or private equity investors. Any company using the amended Rule 506 exemption will be required to take reasonable steps (using methods determined by the SEC) to verify that purchasers of its securities are accredited investors.

In addition, the new law provides that, with respect to Rule 506 offerings, any person that maintains a platform or mechanism to facilitate the offering or sale of securities, or permits general solicitation or general advertising, will not be required to register as a broker or dealer, provided that such person receives no compensation in

connection with the purchase or sale of such security, does not have possession of customer funds or securities and is not subject to a statutory disqualification.

Rule 144A Offerings. The SEC is required to revise Rule 144A, not later than ninety (90) days after the date of enactment of the JOBS Act, to provide that securities sold under Rule 144A may be offered to persons who are not qualified institutional buyers, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on its behalf reasonably believe is a qualified institutional buyer (as defined by Rule 144A). Although the new law may change the manner of resale offerings under Rule 144A for "PIPE" transactions and sales of unregistered debt securities, it remains to be seen what impact, if any, the change will have on the issuer's initial Section 4(2) exemption for the private placement to the initial purchasers or placement agent of such securities.

III. Registration Exemption for Crowdfunding Offerings

Title III of the JOBS Act creates a new exemption from Securities Act registration for "crowdfunding" offerings. Crowdfunding refers to an offering to a potentially large group of investors who are restricted in the amount of money that they can invest in an issuer, and is usually associated with the idea of soliciting funds through internet websites. Crowdfunding offerings will now be permitted under the exemption provided by Section 4(6) of the Securities Act if the following conditions are met:

- the issuer is a U.S. company that is neither subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act nor an investment company under the Investment Company Act of 1940;
- the aggregate amount of securities sold to all investors by the issuer during the preceding twelve (12) month period is not more than $1 million;
- the aggregate amount sold to any investor by an issuer during the preceding twelve (12) month period does not exceed the greater of:
    - $2,000 or 5% of the annual income or net worth of the investor, if the annual income or net worth of the investor is less than $100,000; and
    - Ten percent (10%) of the annual income or net worth of the investor, if the annual income or net worth of the investor is equal to or more than $100,000, subject to a maximum aggregate cap of $100,000 for such investor;
- the transaction is conducted through a broker or funding portal that complies with new Section 4A of the Securities Act (as described in "Requirements for Intermediaries" below); and
- the issuer complies with the requirements of new Section 4A (as described in "Requirements for Issuers" below).

Requirements for Intermediaries. To qualify for the crowdfunding exemption under Section 4(6) of the Securities Act, a person acting as an intermediary must:

- register with the SEC as a broker or a funding portal;
- register with any applicable self-regulatory organization;

- provide risk and other investor education disclosure as the SEC may determine;
- ensure that each investor reviews investor education information, affirms that such investor understands the risk of losing its entire investment, and answers questions demonstrating an understanding of the level of risk in investing in startups and emerging businesses, including the risk of illiquidity;
- take steps to reduce the risk of fraud (as determined by the SEC), including background checks on each officer, director and holder of more than 20% of the outstanding equity of every issuer whose securities are offered by such person;
- make available to the SEC and to potential investors any information required to be provided by the issuer not later than twenty-one (21) days prior to the first sale of securities to any investor;
- ensure that offering proceeds are only provided to the issuer when the aggregate amount raised from all investors is equal to or greater than the target offering amount, and allow all investors to cancel their commitments to invest (as the SEC by rule shall determine);
- ensure that no investor in a twelve (12) month period has purchased securities offered pursuant to Section 4(6) that, in the aggregate, from all issuers, exceed the investment limits of Section 4(6);
- takes steps to protect the privacy of information collected from investors;
- not compensate promoters, finders or lead generators for providing the intermediary with the personal identifying information of any potential investor;
- prohibit the intermediary's directors, officers or partners from having any financial interest in an issuer using its services; and
- meet such other requirements as the SEC may determine for the protection of investors.

Requirements for Issuers. To secure the Section 4(6) exemption, an issuer must:

- file with the SEC and provide to investors and the broker or funding portal certain information about the issuer, including the names of its directors and officers, a description of the business and financial condition of the issuer, the intended use of the proceeds of the offering, the target offering amount, the price or method for determining the price of the securities and the ownership and capital structure of the issuer;
- refrain from advertising the terms of the offering, except for notices that direct investors to the funding portal or broker;
- refrain from paying compensation to any person to promote its offerings through communication channels provided by a broker or funding portal, except as may be disclosed in accordance with SEC rules;
- not less than annually, file with the SEC and provide to investors reports of the issuer's results of operations and financial statements as the SEC shall determine by rule; and
- comply with all other requirements that the SEC may prescribe for the protection of investors.

Other Key Provisions. In addition to the registration exemption under Section 4(6) of the Securities Act, the new crowdfunding law provides that any securities issued under the exemption are "covered securities" for purposes of exempting those securities from state securities registration and offering requirements. Resales of securities issued under Section 4(6) will be restricted during the one (1) year period beginning on the date of purchase, unless the securities are transferred to the issuer, an accredited investor, as part of a SEC-registered offering, to a

family member or in connection with the death or divorce of the purchaser. The new crowdfunding law also provides for civil liability that is similar to Section 12(a)(2) of the Securities Act for any misstatements or omissions in the offer or sale of a security in a transaction exempted by Section 4(6). The SEC has 270 days from the date of enactment of the JOBS Act to promulgate rules implementing the crowdfunding exemption.

IV. Registration Exemption for Offerings Not Exceeding $50 Million

Title IV of the JOBS Act requires the SEC to adopt an exemption from registration under Section 3(b) of the Securities Act for offerings of up to $50 million within a twelve (12) month period. This provision is intended to address the $5 million offering amount limitation contained in Section 3(b) of the Securities Act and in Regulation A adopted by the SEC. Regulation A has not been used often in the past because of the low offering amount limitation and the requirement to prepare and file an offering circular with the SEC. The new exemption is limited to equity securities, debt securities and debt securities convertible or exchangeable into equity securities. The securities may be offered and sold publicly and will not be considered "restricted securities" within the meaning of the federal securities laws. The issuer of the securities is permitted under this exemption to "test the waters" by soliciting interest in the offering prior to filing any required offering statement. The SEC is required to review the offering amount limitation every two years and increase the amount as it determines appropriate.

Under the new law, the SEC must require issuers to file audited financial statements with the SEC annually. The SEC is given authority to determine any additional terms, conditions or requirements that it deems necessary for the protection of investors, which may include:

- a requirement that the issuer prepare and file with the SEC and distribute to prospective investors an offering statement that contains audited financial statements, a description of the issuer's business operations, its financial condition, its corporate governance principles, its use of investor funds and other information as determined by the SEC;
- a requirement that issuers make available to investors and file with the SEC periodic disclosures regarding the issuer as determined by the SEC; and
- disqualification provisions under which the exemption will not be available to certain issuers or their affiliates, officers, directors, underwriters or other related persons.

Unlike the crowdfunding exemption discussed above, offerings under this exemption will be treated as "covered securities" and exempt from state securities laws only if they are listed on a national securities exchange or offered or sold to a qualified purchaser as defined by the SEC. The Comptroller General is required to conduct a study on the impact of state securities laws on offerings made under Regulation A and report the findings to Congress not later than three (3) months after the date of enactment of the JOBS Act.

Although the amendment to Section 3(b) of the Securities Act is effective upon the date of enactment, the new registration exemption will not be available to issuers until the SEC adopts implementing regulations.

V. Changes to Threshold For Registration Under the Exchange Act

Issuers with More Than $10 Million in Assets. Title V of the JOBS Act increases the threshold for registration of private companies under Section 12(g) of the Exchange Act by increasing the number of record holders, as determined by the issuer at the end of each fiscal year, from 500 persons to either (i) 2,000 persons or (ii) 500 persons who are not accredited investors (as defined by the SEC). This change means that private companies can stay private for a longer period of time before being required to assume the governance and reporting responsibilities of a public company.

Any securities held by persons who received those securities pursuant to an employee compensation plan in transactions exempt from registration under the Securities Act (such as Rule 701) are excluded from the definition of "held of record." Also excluded from the record holder calculation will be purchasers of securities pursuant to the crowdfunding exemption following adoption of rules by the SEC not later than 270 days after the date of enactment of the JOBS Act.

The threshold for terminating registration under Section 12(g) will remain at 300 persons for all issuers other than banks and bank holding companies (as discussed below). As a result, the new law will not benefit non-bank reporting companies that would seek to "go dark" by no longer reporting under the Exchange Act. The provisions of Title V are effective upon enactment.

Banks and Bank Holding Companies. Title VI of the JOBS Act amends Section 12(g) of the Exchange Act to raise the threshold for registration for banks and bank holding companies by increasing the number of record holders from 500 persons to 2,000 persons. Unlike other issuers, however, banks and bank holding companies are not required to register under Section 12(g) of the Exchange Act if they exceed 500 record holders that are not accredited.

Prior to the JOBS Act, the threshold for terminating registration under Section 12(g) of the Exchange Act was 300 holders of record for all issuers. After the JOBS Act, a bank or bank holding company may terminate its registration under the Exchange Act if the number of holders of record falls below 1,200 persons. A conforming change was made to Section 15(d) of the Exchange Act to terminate any reporting obligations that may have arisen under Section 15(d). Although the amendments that increase the registration and deregistration thresholds for banks and bank holding companies are effective upon the date of enactment, Title VI provides that the SEC shall issue final regulations to implement the changes within one year of the date of enactment.

Under the new law, it has become more likely that banks and bank holding companies will be able to terminate their Exchange Act registration and avoid the various disclosure and corporate governance requirements of the SEC and the stock exchanges. However, a number of issues are raised by deregistration, including:

- stockholder and trading market concerns to the extent that the issuer is no longer required to publicly disclose material information about the company, including financial information (other than that which is contained in a filing with banking regulators);
- the inability to continue to be listed on a stock exchange, including the NYSE and NASDAQ, resulting in the issuer's stock trading in the over-the-counter market with fewer market makers;
- the ability of insiders to continue to trade in the issuer's stock without providing current or adequate information to the public;
- the necessity to terminate SEC registration statements for employee stock benefit plans, dividend reinvestment plans and shelf offerings; and
- the reduced attractiveness of unregistered stock to target company stockholders in future mergers and acquisitions.

As a result, a bank or bank holding company will need to weigh the costs and benefits in determining whether to terminate its registration under the Exchange Act if the number of record holders is below 1,200 persons.

VI. Timeline for Implementation

The JOBS Act amendments to the federal securities laws, as described above, are generally effective on April 5, 2012, the date of enactment. However, the SEC is required by the JOBS Act to issue implementing regulations for various Titles under the following time frames: Title II (exempt offerings under Rule 506 of Regulation D and Rule 144A) – 90 days from the date of enactment; Title III (exemption for crowdfunding offerings) – 270 days from the date of enactment; Title IV (exemption for offerings not exceeding $50 million) – no date specified; Title V (increasing the threshold for registration under Section 12(g) of the Exchange Act for most issuers) – no date specified; and Title VI (increasing the threshold for registration under Section 12(g) of the Exchange Act for banks and bank holding companies) – one year from the date of enactment.

To the extent that Title I (creating a new category of issuer, the "emerging growth company") prohibits certain regulatory restrictions relating to research reports and securities analyst communications, the SEC and FINRA will need to conform their rules to the provisions of Title I.

For more information about this topic, please contact the author or any member of the Williams Mullen Securities & Corporate Governance or Private Equity teams.