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# JUMPSTART OUR BUSINESS STARTUPS ACT
# A NEW HORIZON FOR EMERGING BUSINESSES

On April 5, 2012, President Obama signed into law the **Jumpstart Our Business Startups Act** ("JOBS Act" or the "Act"). The JOBS Act represents a groundbreaking transformation of the statutory landscape regulating the ability of emerging companies to raise private capital, access the capital markets or, in some cases, remain private. Among other things, the Act:

1. Creates a new class of "Emerging Growth Companies" that will benefit from a streamlined initial public offering process and reduced public disclosure and reporting obligations during their IPO "On-Ramp" period (including the ability to engage in pre-offering "test the waters" communications with institutional accredited investors and qualified institutional buyers).

2. Directs the Securities and Exchange Commission ("SEC") to remove the prohibition on "General Solicitation or General Advertising" in connection with private offerings conducted pursuant to the safe harbors provided by Rule 144A and Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act").

3. Creates a new "Crowdfunding" exemption from the registration requirements of the Securities Act, allowing private companies to sell up to $1 million of securities during a 12-month period to an unlimited number of small investors.

4. Directs the SEC to adopt a "mini-registration" exemption, similar to Regulation A of the Securities Act, and increases the offering size limit to $50 million.

5. Increases the shareholder of record thresholds by which certain issuers are required to register a class of equity securities under the Securities Exchange Act of 1934 (the "Exchange Act").

While some provisions of the Act became operative immediately upon enactment on April 5th, others require further rulemaking by the SEC prior to effectiveness. In addition, given the uncertainty expressed by practitioners and industry participants concerning interpretations of the Act, the SEC staff has issued selected guidance on the new law.

## Streamlined IPO Process

The JOBS Act creates a new class of public company called "Emerging Growth Companies" ("EGCs") that can access the U.S. public capital markets in a new way. EGCs are defined in the Act as issuers with total annual gross revenues of less than $1 billion (indexed for inflation) during their most recently completed fiscal year that did not complete an initial registered public offering of common equity securities ("IPO") on or before December 8, 2011.

An EGC maintains its status until the earliest of (1) the end of the fiscal year in which its annual gross revenues are $1 billion or more, (2) the last day of the fiscal year following the fifth anniversary of its IPO, (3) the issuance of more than

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$1 billion in non-convertible debt in a three-year period, or (4) becoming a "large accelerated filer" under applicable SEC rules.

EGCs also benefit from streamlined IPO "On-Ramp" provisions that afford regulatory reprieves and scaled disclosure options, both in connection with an IPO and for up to a five-year period following an IPO. The following briefly summarizes some of the principal reforms:

*Confidential Filing of an IPO Registration Statement*—Typically, issuers engaging in an IPO are required to submit their IPO registration statement for review publicly through the SEC's EDGAR filing system. However, under the JOBS Act, EGCs will now have the opportunity to submit their draft registration statements to the SEC on a confidential basis for review prior to filing, provided this submission (along with all subsequent amendments) is then filed publicly no later than three weeks before an EGC begins its public roadshow. These confidential submissions to the SEC will neither be deemed "filed" for purposes of SEC regulations nor accessible by the public pursuant to Freedom of Information Act requests until the public filing is ultimately made.

*"Test the Waters" Communications*—While EGCs remain subject to the anti-fraud provisions of the securities laws, the Act permits oral and written communications by EGCs and their authorized agents with accredited investors and qualified institutional buyers prior to (and after) the filing of a registration statement. This is intended to facilitate a "testing of the waters" assessment by the EGC and its underwriters of potential interest in a proposed offering while circumventing restrictive "gun jumping" provisions otherwise prohibiting these pre-offering communications. The SEC staff has noted in interpretative guidance, however, that an issuer must determine its status as an EGC each time it makes a pre-offering communication of this type.

*Research Reports and Broker-Dealer Participation*—EGCs' management and institutional investors are permitted to meet with research analysts, who will be able to attend pre-IPO meetings arranged by broker-dealers. Broker-dealers will be able to make public appearances and publish research reports on behalf of the EGC prior to, during and after the filing of a registration statement for the offering of common equity securities, even if the broker-dealer is participating in the offering. Further, the Act specifically precludes the SEC and FINRA from limiting such publications within any prescribed period of time after the IPO or before the expiration of lock-up periods following an IPO. The SEC staff has not yet published guidance on the interaction of these provisions of the Act with FINRA Rule 2711 governing analysts.

*Executive Compensation Disclosure Reforms*—An issuer that qualifies as an EGC will be exempt from certain requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act applicable to other publicly traded companies. In particular, EGCs are entitled to comply with only those executive compensation regulations applicable to smaller reporting companies, including omitting Compensation Discussion & Analysis from its registration statement, proxy statements and annual reports. EGCs may also avoid soliciting advisory votes from its shareholders on executive compensation (the so-called "say-on-pay" vote) and are not required to disclose the relationship between executive compensation and issuer financial performance ("pay vs. performance") or the ratio of the chief executive officer's compensation to the median annual total compensation of all other employees.

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*Auditor and Accounting Exemptions*—EGCs are exempt from the auditor attestation requirements of Section 404(b) of Sarbanes-Oxley (i.e. the audit of internal control over financial reporting) for the duration of the "On-Ramp" period. Further, an EGC may elect that any new or revised financial accounting standards promulgated under GAAP will not apply to the EGC until those standards also become applicable to private companies.

*Financial Statements*—EGCs are not required to provide more than two years of audited financial statements in their registration statements (as opposed to three years currently required for other issuers), nor selected financial data in any registration statement, periodic or other report filed with the SEC for any period prior to the earliest audited period presented in their IPO registration statements.

## Removal of Long-Standing Prohibition on General Solicitation and General Advertising in Connection with Private Offerings of Securities under Rule 506 of Regulation D

Although the IPO On-Ramp provisions of the JOBS Act apply only to EGCs, one of the Act's most dramatic modifications to existing law is its removal of the longstanding prohibition on the use by any issuer of general solicitation and general advertising in connection with private placements structured to benefit from the registration safe-harbor provided by Rule 506 under Regulation D of the Securities Act, provided all purchasers of securities offered pursuant to Rule 506 are accredited investors.

The SEC is required to amend Regulation D by July 4, 2012 for this purpose. The revisions to these restrictions on general solicitation and general advertising do not, however, circumvent existing anti-fraud liability otherwise relevant to the disclosure made in connection with the offering, and a company seeking to solicit investment in its securities under these new relaxed standards must take reasonable steps to verify that purchasers are accredited investors.

## Crowdfunding

One of the most controversial provisions of the new legislation allows private companies to raise up to $1 million from the general public through SEC-registered brokers or funding portals in what is known as "crowdfunding." Crowdfunding allows companies to raise limited amounts of capital in exchange for small equity stakes by its subscribers, commonly through the use of the internet or other social-media networks. The new crowdfunding provision provides that $1 million may be raised by a non-public or non-investment company during any twelve-month period, so long as the following conditions are satisfied:

- An individual's investment may not exceed (1) the greater of $2,000 or 5% of the investor's annual income or net worth, if the investor's annual income or net worth is less than $100,000, or (2) 10% of an investor's annual income or net worth—not to exceed a $100,000 investment—if the investor has an annual income or net worth equal to or more than $100,000.

- An SEC-registered broker or funding portal, known as an intermediary, must be used in the crowdfunding transaction. These intermediaries must also register with any applicable self-regulatory organization and ensure that investors understand the risks associated with their investments, conduct background checks on the issuer's

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directors, officers and significant stockholders, make sure no investment limits are exceeded and comply with any other SEC-prescribed requirements.

- Issuers still may not advertise the terms of the offering, but must instead direct potential investors to the registered intermediary. No compensation can be paid to anyone promoting the offering unless measures are taken to ensure proper disclosure of that fact. Issuers will also be required to file target offering amounts and deadlines with the SEC, as well as ongoing updates in regards to reaching those targets.

- Initial disclosures are still required, as the issuer must file with the SEC an anticipated business plan, specified financial statements, a description of the intended use of the capital, and the capital structure of the company, among other things. Further, issuers may be subject to ongoing disclosure requirements with the SEC, including financial statement reporting.

- Securities purchased by investors under the new crowdfunding provisions will still be "restricted shares" that may not be resold for one year from the date of purchase, except to the issuer, to accredited investors, as part of an SEC-registered offering, or to family members or in the event of death or divorce, in the discretion of the SEC. Investors also will enjoy a private right action of rescission for material misstatements or omissions by officers, directors, and partners of the issuer.

- Securities acquired pursuant to a crowdfunding compliant offering are exempt from state blue sky registration or qualification requirements.

The SEC released interpretive guidance reminding investors that, until it becomes effective, any offers or sales of securities purporting to rely on the crowdfunding exemption would be illegal under current federal securities laws. The SEC is required by the Act to adopt rules implementing these provisions within nine months from its passage (or December 31, 2012).

## Expanded "Mini-Registration" Exemption (Regulation A)

The Act directs the SEC to adopt a new "mini-registration" exemption (or amend existing Regulation A), and raises the amount of debt or equity a non-reporting company may offer under the exemption to $50 million in a twelve-month period. Securities issued pursuant to this exemption will not be restricted securities, may be offered and sold publicly, and the issuer will be required to file annual audited financial statements with the SEC. The Act also directs the SEC to include other terms and conditions deemed necessary to protect investors and in the public interest.

## Exchange Act Registration Thresholds

The Act significantly increases the shareholder thresholds upon which an issuer would be required register a class of its equity securities under the Exchange Act (and thereby be required to start filing periodic reports with the SEC). Under the new law, the obligation to register will not arise until the 120th day after the last day of the first fiscal year in which the issuer had more than $10 million in total assets and a class of equity securities held of record by either (1) 2,000 persons

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or (2) 500 persons who are not accredited investors (for banks and bank holding companies, it is a static 2,000 persons). Prior to the Act, the threshold was 500 record holders.

In addition, generally, in the event the number of shareholders of an issuer (other than a bank or bank holding company) drops below 300 persons, the issuer can file a certification with the SEC or bank regulator attesting to such reduction and have its registration terminated. Banks and bank holding companies are in a special category. If the number of record holders of a class of equity securities of a bank or bank holding company registered under Section 12(g) or 12(i) of the Exchange Act falls below 1,200, it can de-register. This provision will enable many community banks and bank holding companies to raise capital in private offerings without being required to register under Section 12(g) or 12(i) (as applicable) of the Exchange Act.

In addition, in determining the number of record holders, issuers do not need to count securities held by persons who received them under an employee compensation plan in a transaction exempt under the Securities Act.

— **Asher J. Friend, Richard P. Wolfe and Neal C. Wise**

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. *You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:*

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