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JOBS Act enacted, seeks to enhance capital raising by lessening regulatory burden for "emerging growth companies" and by permitting "crowdfunding" capital raising vehicles. SEC and critics charge that Act will enhance opportunity for securities fraud.

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JOBS Act Enacted, Imposes Substantial Deregulation on the Mechanics of Securities Offerings

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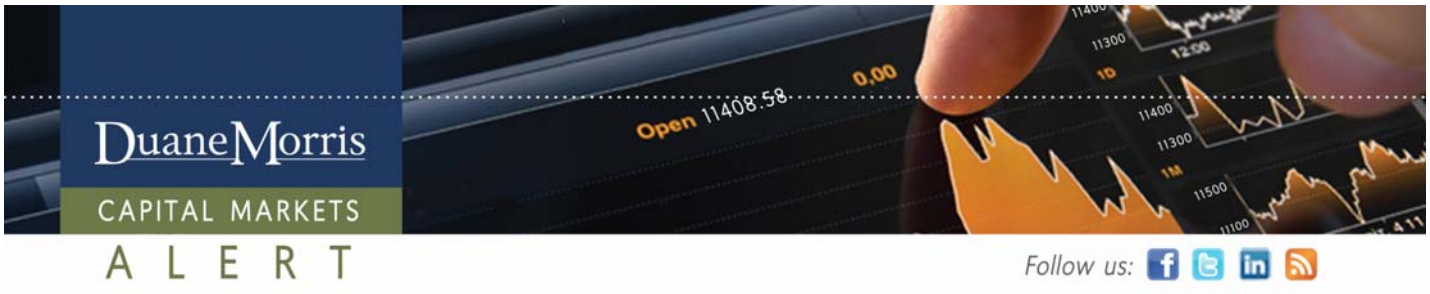
In one of the most sweeping changes to the securities offering environment in years, the Jumpstart Our Business Startups Act, commonly referred to as the JOBS Act, became law on April 5, 2012. The stated purpose of the JOBS Act is to spur job creation by smaller companies, in part by an almost unprecedented relaxation of the regulatory capital raising requirements on small companies. The Act was propelled by a wave of support among the venture capital and startup communities over the sometimes vigorous objections of, among others, the U.S. Securities and Exchange Commission (SEC).

Perhaps the most significant changes are that the JOBS Act: (1) immediately establishes a new category of issuer, emerging growth companies (EGCs), that are subject to a less burdensome registration and reporting regime; (2) establishes a new exemption for securities offerings under the Securities Act for crowdfunding[1]; (3) instructs the SEC to amend Regulation D[2] under the Securities Act to remove the prohibition on general solicitation and general advertising; (4) expands the maximum amount for Regulation A-type offerings to $50 million; and (5) increases the number of shareholders that will require registration under the Exchange Act.[3]

Emerging Growth Companies

For companies completing their initial public offerings (IPOs) after December 8, 2011, a company[4] with annual gross revenues of less than $1 billion in its most recent fiscal year will qualify as an EGC under the JOBS Act. An EGC may retain that status for up to five years following its IPO.[5]



The Act exempts an EGC from various Securities Act disclosure requirements, including:

(1) auditor attestation of internal controls and procedures[6];
(2) preparation and inclusion of a Compensation Discussion and Analysis section (CD&A);
(3) holding stockholder advisory votes on executive compensation ("say-on-pay") and golden parachute compensation;
(4) disclosure of the relationship between performance of the company and executive compensation actually paid, and the ratio between total annual compensation of the CEO and the median of total annual compensation of all employees[7];
(5) compliance with new or revised accounting standards until those standards are applicable to private companies;
(6) providing detailed executive compensation disclosure[8]; and
(7) any Public Company Accounting Oversight Board (PCAOB) rules regarding mandatory audit firm rotation.[9]

In addition, only two years of audited financial statements will be required in an IPO registration statement rather than the three years of audited financial statements required before enactment of the Act.

Two of the most far-reaching benefits under the Act for an EGC relate to expanding communications ahead of offerings and the ability of an EGC to file with the SEC a draft IPO registration statement for its review and comment prior to filing its public IPO registration statement.[10] EGCs are not subject to the restrictions on communications provided that the EGC or those acting on its behalf communicates only with potential investors that are qualified institutional buyers or accredited investors – this will allow an EGC to solicit interest from accredited investors and qualified institutional buyers (QIBs) in a contemplated offering before filing any registration statement (*i.e.*, test the waters). In addition, EGCs are not, at least initially, required to publicly file with the SEC an IPO registration statement; instead, they can submit a draft IPO registration statement and amendments to the SEC on a confidential basis as long as the confidential submissions are publicly filed with the SEC at least 21 days prior to the start of any road show. Any SEC comment letters (and company response letters as well as the filed drafts of the registration statement and amendments) relating to the draft IPO registration statement of an EGC are treated as confidential information and may not be made publicly available via EDGAR and will be exempt from disclosure under the Freedom of Information Act.

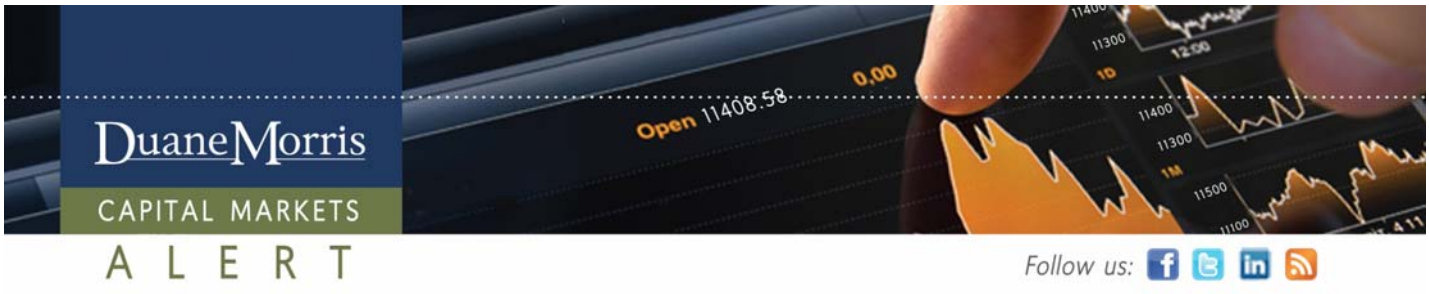
Crowdfunding

Perhaps the most discussed provision of the JOBS Act is the creation of a new exemption under the Securities Act for capital raising activities through crowdfunding. Until the SEC acts to adopt required regulations, it is unknown exactly how this new exemption will operate. Nevertheless, the JOBS Act provides that: (1) the total amount of securities sold by the issuer, including amounts sold in reliance on the crowdfunding exemption during the preceding 12 months, cannot exceed $1 million; (2) the total amount of securities sold to any single investor by the issuer, including amounts sold in reliance on the crowdfunding exemption during the preceding 12 months, cannot exceed specified amounts based on the annual income or net worth of the investor[11]; (3) transactions must be conducted through either brokers or funding portals which comply with specified requirements[12]; and (4) the issuer must comply with certain additional requirements, including filing specified information with the SEC and making available such information to brokers, funding portals and potential investors.[13] The Act presents a serious degree of uncertainty in the crowdfunding process by requiring the intermediary, prior to the time that the minimum target offering amount is achieved, to allow all investors to cancel their investment commitment as the SEC by rule deems appropriate.[14]

Securities acquired by crowdfunding may not be transferred for one year from the date of purchase (except in limited circumstances). Such securities are "covered securities" and therefore are exempt from state blue sky registration requirements. Finally, such securities are not deemed "held of record" for purposes of calculating the number of record holders when determining whether registration under the Exchange Act is required.[15]

General Solicitation Under Regulation D Rule 506 and Rule 144A

For offerings under Rule 506 of Regulation D, the JOBS Act requires the SEC to remove the prohibition against general solicitation and general advertising, as long as all purchasers of securities under the Rule 506 offering are accredited investors.[16] Similarly, the SEC is instructed to amend Rule 144A to allow securities to be offered to non-QIBs (including by means of general solicitation or general advertising), as long as actual sales are made only to persons the issuer reasonably believes to be QIBs. Intermediaries that assist with introducing issuers and purchasers will receive relief from being required to register as a broker-dealer if the intermediary meets certain requirements. However, until the SEC acts to implement these provisions of the JOBS Act, it is hard to foretell exactly what the contours of this relief will entail.



New Exemption Under Section 3(b) of Securities Act

The JOBS Act instructs the SEC to issue implementing rules or regulations for a new exemption under Section 3(b) of the Securities Act. This new exemption will be in addition to the existing Regulation A,[17] and will allow offerings of securities by an issuer in a streamlined fashion in amounts not to exceed $50 million during the preceding 12 months. Although the SEC is given substantial latitude in establishing the final parameters of this exemption, issuers relying on the exemption will be required to file annual audited financial statements with the SEC. In addition, the SEC is permitted to require filing and delivery of an offering statement and periodic disclosures.[18]

Increased Threshold for Exchange Act Registration

The JOBS Act increases the registration threshold under Section 12(g) of the Exchange Act for all companies (including foreign private issuers). Once implemented by the SEC,[19] issuers will be required to register a class of equity securities under the Exchange Act if the securities are held *of record* by either (1) 2,000 persons or (2) 500 persons who are not accredited investors, raising the level from the historical threshold of 500 record holders (regardless of accredited investor status).[20] The JOBS Act further provides that the following securities will not count as being "held of record" for purposes of the calculation: (1) securities held by employees who received them under an employee compensation plan in a transaction exempt from registration under the Securities Act[21] and (2) securities issued under the new crowdfunding exemption.[22]

The JOBS Act and the rules adopted by the SEC as required under the Act should make it easier for issuers to raise funds for their enterprises. However, in view of the lesser degrees of required disclosure under the Act as well as the sharp views expressed by the SEC on the relaxed disclosure regime under the JOBS Act, issuers should be aware that the SEC will most likely be vigilant in its monitoring and review of issuer activity under the JOBS Act, in its effort to prevent fraud in these less-restrictive offerings enabled by the JOBS Act.

For Further Information

If you have any questions about the JOBS Act and the topics discussed in this *Alert*, please contact Richard A. Silfen; Jay Coogan; Nanette C. Heide; David J. Kaufman; Laurence S. Lese; Darrick M. Mix; any of the members in our Securities Law Practice Group; or the attorney in the firm with whom you are regularly in contact.

1 The JOBS Act doesn't define "crowdfunding." Wikipedia defines the term as: "'Crowd funding' (alternately crowdfunding, crowd financing, equity crowdfunding, crowd sourced capital or street performer protocol) describes the collective cooperation, attention and trust by people who network and pool their money and other resources together, usually via the Internet, to support efforts initiated by other people or organizations."

2 The Act also directs the SEC to revise Rule 144A under the Securities Act to provide that securities sold under that exemption may be offered to persons other than qualified institutional buyers (QIBs), including by means of general solicitation or general advertising, as long as the securities are sold only to persons that the seller reasonably believes are QIBs.

3 The changes relating to EGCs are effective immediately, while the other provisions require additional rulemaking by the SEC. Because the SEC has yet to complete the rulemaking process required under the Dodd-Frank Act, it is uncertain when the SEC will be able to focus on the rulemaking required under the JOBS Act.

4 Including foreign private issuers.

5 Unless the company earlier: (1) achieves annual gross revenues of more than $1 billion, (2) issues more than $1 billion of non-convertible debt during the previous three-year period or (3) achieves "large accelerated filer" status.

6 Under Section 404(b) of the Sarbanes-Oxley Act of 2002.

7 Once implemented by the SEC.

8 Only compliance with the smaller reporting company disclosure is required.

9 The Act also offers relief from SEC rules restricting research reports on EGCs (including by syndicate members).

10 On April 10, 2012, the SEC issued guidance entitled "Frequently Asked Questions – Confidential Submission Process for Emerging Growth Companies." The link to this guidance follows: http://sec.gov/divisions/corpfin/guidance/cfjumpstartfaq.htm.

11 The Act limits the investment by any person during a 12-month period preceding the date of the transaction to not more than: (1) the greater of $2,000 or 5 percent of the annual income or net worth of the investor if either the annual income or net worth is less than $100,000 or (2) 10 percent of the annual income or net worth of the investor, not to exceed $100,000 if the annual income or net worth is equal to or more than $100,000. Moreover, the Act requires all crowdfunding transactions to be conducted through a broker or "funding portal," as defined by the Act, that complies with further requirements under the Act.

12 The Act uses the word "intermediary" to refer to a broker or funding portal. The intermediary must be registered with the SEC, must provide SEC-specified disclosure related to risks and other investor education information, must take certain measures to reduce the risk of fraud, must permit cancellation of commitments, and must undertake efforts to ensure that no investor purchases securities under the crowdfunding exemption during any 12-month period from all issuers in excess of the limits imposed on such individual. Indeed, the intermediary must ensure that each investor: (a) reviews investor-education information, (b) positively affirms that the investor understands that the investor might lose the entire investment and (c) answers questions demonstrating an understanding of the level of risk involved, including the risk of illiquidity; and must ensure that all offering proceeds are provided to the issuer only after the aggregate capital raised is equal to or greater than the target offering amount.

13 Including financial information (the extent of which depends on the amount of crowdfunding activity undertaken by the issuer during the preceding 12 months) and information about the final price to the public or the method for determining the price. An issuer will need to file annual reports with the SEC on the issuer's results of operations and financial statements, as the SEC determines by rule to be appropriate.

14 This provision is less meaningful if the offering period is modest, but could potentially be substantially disruptive where the issuer has established a long offering period, during which an investor might choose to rescind his or her investment, thereby potentially throwing the offering into disarray.

15 An issuer of crowdfunding securities will have liability similar to that under Section 12(a)(2) of the Securities Act. The JOBS Act defines "issuer" for this purpose to include any person who is a director, or partner of the issuer, and the principal executive officer, principal financial officer, and controller or principal accounting officer, as well as any person who offers or sells the security in the offering.

16 The issuer will need to take reasonable steps to verify that all purchasers are in fact accredited investors. The Act amends Section 4 of the Securities Act to provide that offers and sales exempt under Rule 506 will "not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." It is our understanding that the JOBS Act, by the requirement that the SEC amend Rule 506, does not disturb the current Rule 506 exemption regarding sales to up to 35 non-accredited investors and without limit on the number of accredited investors, as long as there is no general advertising and no general solicitation.

17 It appears that the Act created an anomaly in amending Section 3(b) of the Securities Act. As amended, new section 3(b)(1), which formerly was section 3(b) that spawned Regulation A offerings having an offering ceiling of $5 million, remains effective with a ceiling of $5 million and presumably would remain available and effective for Regulation A offerings. The Act created new section 3(b)(2), which has a ceiling of $50 million per offering. It is likely that the SEC in its requisite rulemaking process will provide guidance regarding these two sections and their availability and usage.

18 Securities sold under the exemption may be offered and sold publicly; and issuers may be permitted to solicit interest before filing any offering statement with the SEC. Securities sold under this exemption will not be considered "restricted securities" and will be considered "covered securities" and thereby will be exempt from state blue sky registration requirements, as long as the securities are offered or sold on a national securities exchange or solely to qualified purchasers (a concept from the Investment Company Act of 1940, but to be defined by the SEC for Section 3(b) purposes).

19 On April 11, 2012, the SEC issued guidance entitled "Frequently Asked Questions – Changes to the Requirements for Exchange Act Registration and Deregistration." The link to this guidance follows:
http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-12g.htm.

20 Consequently, issuers will need to implement an ongoing mechanism to determine whether holders of their equity securities are accredited investors. The other registration predicate for Exchange Act registration is that on the last day of its fiscal year, the issuer had total assets in excess of $10 million.

21 Rule 701 under the Securities Act.

22 Similar changes are to be implemented by the SEC with respect to banks and bank-holding companies, except there is no limitation based on the number of persons who are not accredited investors. In addition, banks and bank-holding companies will be permitted to deregister under the Exchange Act and suspend their reporting obligations if the number of record holders of the security falls below 1,200 persons (rather than the 300-person threshold applicable to other issuers).