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U.S. Securities Laws Poised for Major Shift as 'JOBS Act' Goes to President for Signature

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Overview

On March 27, 2012, the U.S. House of Representatives approved a package of legislation collectively referred to as the “Jumpstart our Business Start-ups Act” (JOBS Act). The JOBS Act was previously approved by the U.S. Senate, and now goes to the president for signature, which is expected in the coming days. The JOBS Act substantially liberalizes the legal framework for private placements of securities in the United States, and aims to facilitate initial public offerings by reducing the regulatory burden for small and mid-cap public reporting companies.

Broadly speaking, the JOBS Act will amend the U.S. federal securities laws to permit the following:

•Public advertising and promotion of private securities offerings

•Public issuers with annual revenues of up to $1 billion to be exempt for up to five years from many of the financial control and reporting requirements instituted by the Sarbanes-Oxley Act of 2002

•Expansion of privately held companies’ shareholder base to up to 2,000 holders without requiring Securities & Exchange Commission (SEC) reporting, allowing a significant expansion of private trading markets

•Sale of securities to investors through “crowdfunding” portal sites

•A substantial increase in the size of placements through Regulation A private offerings to large financial institutions

The legislation represents an initiative by Congress to revise the ground rules for the sale of securities in the United States that in some instances date back to the 1930s. The JOBS Act, which passed both

chambers of Congress with bi-partisan support, aims to make it easier for small businesses and emerging growth companies to raise capital by casting a much wider net for prospective investors than permitted under current securities laws.

Reduced Compliance Requirements for 'Emerging Growth Companies'

The JOBS Act seeks to ease the path toward initial public securities offerings by reducing the public reporting burden imposed on small and mid-cap public reporting companies:

•The Act creates a new category of “Emerging Growth Companies” (EGCs) – defined as companies with annual gross revenues of less than $1 billion, that have been public reporting companies for a period of less than five years, and that do not have a public float of $700 million or more in securities held by non-affiliated holders. Only companies that completed their initial public offerings after December 8, 2011, may qualify as EGCs.

•For this group of newly public companies, the JOBS Act effectively “phases in” many of the potentially burdensome reporting requirements that otherwise apply to public reporting companies, on the assumption that doing so will lower the hurdle for companies seeking access to the public capital markets.

•Among the changes applicable to EGCs:

◦EGCs will need to include only two years of audited financial statements (and related management discussion and analysis and selected financial data) in their initial registration statements

◦EGCs will be subject to reduced executive compensation normally applicable to smaller reporting companies, and will be exempt from the enhanced compensation disclosure and analysis requirements under the Dodd-Frank Act of 2010

◦EGCs will not be required to comply with shareholder voting requirements on named executive officer compensation (“say on pay”) under the Dodd-Frank Act

◦EGCs will not be required to supply an auditor attestation of their financial reporting controls in their annual reports on Form 10-K

◦Unless otherwise determined by the SEC, EGCs will be exempt from any audit firm rotation or supplemental auditor disclosure requirements that may otherwise apply

◦EGCs will not be required to comply with new U.S. GAAP accounting standards and pronouncements, until these become applicable to privately held companies

•The JOBS Act authorizes prospective IPO candidates to file registration statements with the SEC in draft form and on a confidential basis, and to delay public availability of their registration materials until 21 days prior to commencing their offering "road show."

•The legislation directs the SEC to conduct a study of the impact of the move to quoting securities on exchanges in one-penny increments ("decimalization"), which some observers have pointed to as a contributing factor in the decline in IPO volume over the past decade by reducing the incentives for investment banks to make a market for small and mid-size offerings.

•The Act also directs the SEC to undertake a review of the disclosure rules under Regulation S-K, and endeavor to modernize and simplify these rules for EGCs.

Relaxed Analyst Communication Rules for IPOs of ECGs

The JOBS Act eliminates key restrictions on publishing analyst research, and communications between securities analysts, investment bankers, management, and prospective investors, while IPO registrations of EGCs are underway:

•Investment bank analysts will be permitted to publish research reports on EGCs while their IPO registrations are pending, even if the investment bank is a member of the underwriting syndicate

•Analysts will also be permitted to communicate with EGC management and investment bankers, exempting underwriters from the conflict of interest rules that would otherwise apply

•An issuer will be able to communicate with and canvass interest from qualified institutional buyers (QIBs) and institutional accredited investors, either before the issuer's registration statement is filed or while registration is pending

•The SEC and national securities exchanges will be prohibited from imposing restrictions on publishing research or public appearances relating to EGCs during the post-IPO quiet periods and lock-up periods

Liberalized Private Placement Rules

The JOBS Act removes many of the restrictions on companies raising capital through private placements of their securities, in some ways blurring the dividing line between private placements and public offerings.

The Act amends various provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 to permit the following:

General Solicitation and Advertisement of Private Offerings

The legislation requires the SEC to adopt rules permitting companies to engage in public solicitation of investors in a private offering under Rule 506 of Regulation D, so long as participation in the offering is limited to “accredited investors.”

A fundamental tenet of current U.S. securities laws is that solicitation of prospective investors through media and public appearances is permissible only in the context of a registered public offering. The Act amends the private offering exemptions under the Securities Act to permit certain general solicitation and advertisement of ostensibly private offerings.

In principal, it would appear that issuers will be able to advertise offerings online, and in print, broadcast and other media, as long as issuers implement adequate procedures to exclude non-accredited investors and otherwise comply with the requirements of Rule 506.

Public advertising and solicitation is also to be permitted in private placements to QIBs under Regulation A.

Expanded Offerings to Institutional Investors

The JOBS Act significantly enhances the flexibility of issuers to sell securities to QIBs under the Regulation A offering exemption.

The Act directs the SEC to promulgate rules expanding the maximum offering size for Regulation A offerings from $5 million to $50 million, allowing issuers to solicit investor interest prior to filing an offering statement with the SEC, and allowing public solicitation of investment interest. Issuers undertaking an offering under the amended Regulation A will be subject to annual public reporting requirements.

Regulation A offerings are currently rare, because of the perception that the compliance costs associated with these offerings are disproportionate to the relatively low offering cap. The substantially increased offering size limitation may make Regulation A significantly more attractive for many issuers.

Increase in Maximum Shareholder Rules

Current securities laws require issuers to register with the SEC and start filing periodic reports at such time as any class of their equity securities is held of record by 500 or more persons (unless the issuer has assets of less than $10 million). The JOBS Act raises the shareholder count ceiling significantly, to a maximum of 2,000 holders of record. Of that number, no more than 500 holders may be non-accredited investors. Persons receiving securities through equity compensation plans are excluded from the shareholder count.

Taken together, the private offering provisions amount to Congress' endorsement of the recent emergence of secondary trading markets in securities of private issuers, and effectively offer privately held companies an alternative path toward a broader shareholder base with greater liquidity, without complying with the full regulatory burden of becoming a public reporting company.

Crowdfunding and Online Trading Portals

The JOBS Act creates a new exemption from the federal registration requirements for small offerings raised through "crowdfunding" mechanisms. A portion of the legislation referred to as the "CROWDFUND Act" seeks to allow small issuers to employ online tools to raise capital in small increments from a broad investor base, while instituting investor safeguards primarily in the form of enhanced disclosure requirements.

Issuers launching a "crowdfunded" offering under this exemption will need to meet requirements that include:

•**Offering Limit**: Capital raised by an issuer from all investors under this exemption may not exceed $1 million in any 12-month period

•**Investment Limit:** The aggregate amount of securities sold to any investor by an issuer in any 12 month period may not exceed:

◦The greater of $2,000 or 5 percent of the investor's annual income or net worth, as applicable, for investors with annual income or net worth of less than $100,000, or

◦10% of the investor's annual income or net worth, up to a maximum of $100,000 for investors with annual income and net worth of more than $100,000

•**Public Disclosure Requirements:** The issuer must file a report with the SEC, and make the information it contains available to prospective investors. The information reported must include:

◦Financial information, the extent and nature of which varies based on the size of the offering: (1) tax returns and financial statements certified by an executive officer of the issuer, for offerings up to $100,000; (2) financial statements reviewed by an independent auditor for offerings of $100,000 to $500,000; and (3) audited financial statements for offerings of more than $500,000

◦A description of the issuer's business and business plan, and intended use of proceeds from the offering

◦The target offering amount to be raised and a stated deadline for reaching the target offering amount (absent which the offering must be cancelled)

◦The pricing of the securities or a description of the method to be used to price the securities prior to closing the offering

◦Disclosure about the issuer's management and current ownership

◦Additional information that the SEC may require in the implementing rules

•**Annual Reporting:** After completion of the offering, the issuer will be required to file annual financial reports with the SEC, subject to any exceptions or phase-out periods that the SEC may implement

•**Offering Through Portal or Broker/Dealer:** The offering must be conducted through a qualifying crowdfunding "portal" or through a registered broker/dealer

•**Limits on Advertising:** The placement may not be publicly advertised, other than by posting notices directing prospective investors to the crowdfunding portal or broker for more information

•**Limits on Intermediaries:** The issuer may not compensate third parties for promoting the offering without complying with prominent disclosure requirements to be further defined by the SEC

•**Lock-up Requirement:** Investors in crowdfunded offerings are required to agree to not resell the purchased securities for a period of 12 months, other than to accredited investors or affiliated persons, or pursuant to a registered public offering

•**Issuer Qualifications:** To qualify for the crowdfunding exemption, an issuer must be organized in the United States, not currently be subject to public reporting requirements under the Securities Exchange Act, and not be a regulated investment company under the Investment Company Act of 1940

The legislation leaves it to the SEC to define many of the specifics of how crowdfunding mechanisms may be employed. The precise contours of permissible crowdfunded offerings will therefore emerge only after final SEC rulemaking.

Crowdfunding Portal Requirements

The crowdfunding model as defined by Congress will rely heavily on the emergence of crowdfunding portals, which portals will be the primary mechanism by which securities are offered to the public. The CROWDFUND Act does not require that crowdfunding portals register as broker/dealers, so long as they comply with requirements enumerated in the CROWDFUND Act and additional regulations that the SEC may implement.

These requirements of the Act include:

•Registering with an applicable self-regulatory organization (efforts to form one or more such organizations are reportedly currently underway)

•Providing investors with disclosures and education materials regarding investment risks
Implementing mechanisms to ensure that investors review and confirm their understanding of the disclosures in the issuer offering materials

•Taking measures to reduce the risk of fraud (such measures to be further defined by the SEC)

•Regulating the receipt and holding of investor funds, such that investor funds are released to the issuer only when the issuer's defined investment "target" is met for the offering

•Taking measures to ensure that individual investors do not exceed their applicable investment limitations under the Act

•No compensation for promoters, finders or lead generators for sourcing and identifying investors to the portal

•Barring officers, directors and partners of the portal operator from holding any financial interest in an issuer

State Securities Law Preemption

The CROWDFUND Act limits the extent to which issuers in crowdfunded offerings and crowdfunding portals must comply with state securities registration requirements. States are pre-empted from charging filing fees in connection with crowdfunded offerings, with the sole exception of any state in which purchasers of 50% or more of the securities sold in an offering reside. The ability of state securities regulators to undertake enforcement actions is largely preserved.

Trading Platforms Exempted from Broker/Dealer Regulations

The CROWDFUND Act exempts online services that facilitate placement or trading of securities from being classified as securities brokers or dealers, thereby exempting them from the SEC registration and reporting requirements that would otherwise apply. Services exempt under this provision include companies providing due diligence review tools and standardized transaction documentation. In order to fall within the exemption, providers must observe defined restrictions on their activities, including refraining from charging commissions for the purchase and sale of securities or holding possession of customer funds or securities.

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Alternative Liability Standards

The legislation defines a different liability standard for claims brought by investors against issuers of securities in crowdfunded offerings. Such issuers are liable for investor losses arising out of material misstatements or omissions in any written or oral communications made in connection with their offering, provided that the investor did not know of the misstatement or omission. The issuer may defend against such claims if it can show that it (including its directors and senior officers) did not know, and could not have known in the exercise of reasonable care, of the material misstatement or omission.

Timeline

While certain provisions of the JOBS Act will take effect immediately when the legislation is signed into law by the president, many of the material aspects of the Act will require further rulemaking from the SEC to take effect.

The Commission is required to release enabling rules in as little as 90 days after enactment with respect to certain aspects of the legislation, including general solicitation rules for private offerings under Regulation D. The SEC has up to 270 days to release rules for other portions of the Act, including the crowdfunding exemption and crowdfunding portal regulations. Accordingly, assuming the JOBS Act is signed into law in its current form, as a practical matter, certain of the new offering exemptions should first become available to issuers in early 2013.

The full text of the JOBS Act can be found here.

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