President Obama Signs the Jumpstart Our Business Startups (JOBS) Act: An Attempt to Ease Access to Capital and Reduce Regulatory Hurdles for Small and Emerging Businesses

Earlier today (April 5, 2012), President Obama signed the Jumpstart Our Business Startups Act (the “JOBS Act” or the “Act”). The signed Act is largely unchanged from its original House version, which passed overwhelmingly through the House by a massive 390-23 margin, and similarly passed through the Senate by a 73-26 margin with only one amendment. In a rare product of election year bipartisanship, the Act attempts to make it easier for small and emerging businesses to raise capital and create jobs by relaxing several existing securities regulations. However, because the Act passed so swiftly, it did not receive the scrutiny usually given to such extensive legislation. Accordingly, numerous ambiguities and questions remain which will need to be resolved through SEC rulemaking or otherwise. Specifically, the Act:

- Removes the prohibition on general solicitation in connection with private offerings under Rule 506 or Rule 144A under the Securities Act of 1933, as long as sales are made only to qualified investors;
- Adds an exemption to the Securities Act for “crowdfunding” offerings (soliciting small investments from a large pool investors over the Internet) of up to $1 million in a 12-month period;
- Provides an IPO on-ramp for “emerging growth companies” by relieving such companies from various requirements and restrictions applicable to IPOs, and allowing them to phase in certain ongoing reporting requirements over up to a five-year period;
- Authorizes the SEC to increase the amount allowed to be raised in a Regulation A offering from $5 million to $50 million in any 12-month period; and
- Increases the thresholds for the number of shareholders that trigger registration of an issuer’s securities under Section 12(g) of the Securities Exchange Act of 1934.

Several of the provisions of the JOBS Act are effective immediately; however, many other provisions (including the crowdfunding provisions) require SEC rulemaking, which may take an additional nine months (270 days) or longer.

DISCUSSION

Removal of General Solicitation Restrictions

The JOBS Act directs the SEC to eliminate the prohibition on general solicitation for offerings under Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933, by amending those rules within the next 90 days. For Rule 506, the prohibition against general solicitation or general advertising will not apply to offers and sales of securities made under the Rule, as long as all purchasers of the securities are accredited investors. Generally speaking, accredited investors include (1) banks, insurance companies, and certain investment companies, (2) entities with total net assets of at least $5 million, or (3) individuals with total net worth of at least $1 million or annual net income of at least $200,000. The SEC recently heightened the standard for individual investors by requiring individual investors to exclude from their net worth any net equity in their principal residence and any equity pulled out of the principal residence through new loans or refinancing within the last 60 days. Individual investors must also include as a liability any amount by which the indebtedness on their principal residence exceeds the estimated fair

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QUESTIONS?

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market value of the residence.

Issuers will be required to take reasonable steps to verify that purchasers of its securities under a Rule 506 offering are, in fact, accredited investors, using methods to be determined by the SEC (which will presumably be included as part of the SEC rulemaking process). Currently, Rule 506 is available in offerings where, among other things, the issuer "reasonably believes" that no more than 35 purchasers are not accredited investors; however, in practice, although Rule 506 allows up to 35 non-accredited investors who are otherwise "sophisticated" investors to invest in the offering, because of additional disclosure requirements that come with offering securities under Rule 506, the vast majority of Rule 506 offerings are made solely to accredited investors.

Likewise, for Rule 144A offerings, securities offered under that Rule may be offered by means of general solicitation or general advertising, as long as securities offered under that Rule are eventually sold only to persons that the seller reasonably believes is a qualified institutional buyer.

Effect of Removal of Restriction on General Solicitation

Removal of the general solicitation ban will significantly change the way private firms, including startup ventures, private equity funds and hedge funds, promote and market their products. Subject to the SEC rulemaking, private firms will be able to promote and market fund and securities offerings through mass media channels, from television to newspaper articles to websites and even cold-call potential investors, so long as the end result is that only accredited investors ultimately purchase the securities offered.

It is likely that the SEC will curtail some of the most egregious solicitation methods to avoid an outcropping of boiler rooms, Ponzi schemes, bucket shops, and garden variety hucksters. However, removal of the general solicitation restrictions will clearly facilitate the raising of early-stage capital over the Internet. And while most private funds that rely on Rule 506 are unlikely to source investors solely through online or print advertising or press coverage, lifting the general solicitation restriction removes the legal uncertainty that information released to the press or posted on a manager's website could jeopardize the availability of the Rule 506 exemption.

Creating a New Exemption for "Crowdfunding"

The JOBS Act creates a new exemption from registration with the SEC for "crowdfunding" offerings. Crowdfunding refers to the process of raising significant amounts of capital by soliciting small investments from a large pool of investors. Under the Act, issuers can offer up to $1 million worth of securities in any 12-month period to an unlimited number of potential investors in crowdfunding offerings, as long as the maximum amount of securities that may be sold to any one crowdfunding investor does not exceed:

- the greater of $2,000 or 5 percent of the annual income or net worth of the investor, as applicable, if the investor's annual income or net worth is less than $100,000, or
- 10 percent of the investor's annual income or net worth, up to an aggregate investment amount of $100,000, if the investor's annual income or net worth, as applicable, is greater than $100,000.

All crowdfunding offerings must be conducted through a registered broker or "funding portal" (an intermediary website registered with the SEC that facilitates the offering but does not solicit investors or take part in the offering). Intermediaries will be required to ensure that crowdfunding investors are able to demonstrate a basic understanding of the level of risk inherent in startups and small business, including the risk that the investor is risking the loss of the entire investment. Intermediaries would also be required to take certain measures to reduce the risk of fraud by issuers through its website, including conducting background checks on principals of the issuers.

Issuers must be organized under domestic law, may not be a company required to file reports under section 13 or section 15(d) of the Exchange Act, and may not be an investment company (as defined in Section 3 of the Investment Company Act of 1940). Prior to any offering, issuers must register with the SEC and make available to investors and the intermediary its business plan and certain financial information (including audited financial statements if the target offering amount is more than $500,000). The issuer may not advertise the offering other than to point potential investors toward the issuer's offering listing on the intermediary's website.

Investors who have been harmed by a material misstatement or omission made by an issuer in a crowdfunding offering would be able to sue the issuer, subject to the provisions of Section 12(b) of the Securities Act, as if the liability were created under Section 12(a)(2) of the Securities Act.

Securities issued in a crowdfunding offering will be "restricted securities" and may not be transferred until one year after the date of purchase, unless sold (a) back to the issuer; (b) to an accredited investor; (c) as part of a registered offering; or (d) to a family member or equivalent affiliated person or in connection with the death or divorce of the purchaser.

Crowdfunded securities and registered crowdfunding intermediaries will be generally exempt from registration requirements under Blue Sky laws, but not from State enforcement action for fraud, deceit or unlawful conduct. States would still be allowed to require notice filings for crowdfunding offerings, similar to Form D notices, but only the state in which the issuer's principal place of business is located and the state in which 50 percent or greater of the investors in the offering reside, if any, may charge a filing fee.

All crowdfunding investors would be excluded in determining whether the issuer has a class of equity securities held of record by either 2,000 or more persons or 500 or more non-accredited investors thereby triggering reporting requirements under Section 12(g) of the Exchange Act.

Pros and Cons of Crowdfunding

Supporters of crowdfunding claim that crowdfunding democratizes access to capital and allows Main Street investors to invest in startup ventures that align with their interests. A common argument of such supporters is that they are allowed to purchase lottery tickets but are not allowed to invest in a local startup that could benefit their community. Supporters of crowdfunding also point to the overwhelming success of websites such as Kickstarter and IndieGoGo, which currently provide a method of crowdfunding that relies solely on donations in exchange for token rewards.

Critics of crowdfunding point to the potential for fraud associated with offering investments in new ventures to unsophisticated investors over the Internet. The Senate responded to these critics by adding an amendment to the JOBS Act that strengthens investor protections and adds significant compliance restrictions for both issuers and intermediaries in crowdfunding offerings. Critics additionally argue that crowdfunding lacks the benefits provided by traditional venture capital and angel investors, such as industry expertise, business experience, and personal connections.

Phasing in Restrictions and Requirements for Emerging Growth Companies Going Public

Reduced Requirements for Emerging Growth Company IPOs

The JOBS Act makes it easier for smaller companies to go public through an initial public offering (IPO) by lessening the initial reporting requirements for such companies and phasing in ongoing reporting requirements once the company is public. Specifically, the Act establishes a new category of issuers under U.S. securities laws called "emerging growth companies" (EGCs). EGCs are defined as an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. A foreign company can be an EGC. A company cannot be an EGC if it first sold its common equity securities in an IPO prior to December 8, 2011.

An EGC that conducts an IPO may:

- provide two years of audited financial statements in its registration statements instead of three years;
- confidentially file registration statements and subsequent amendments with the SEC, if the initial confidential submission and all amendments are publicly filed at

least 21 days prior to the IPO “roadshow”; and
- hold meetings prior to or during a public offering with institutional accredited investors and qualified institutional buyers to “test the waters” to determine whether such investors might have an interest in a contemplated securities offering without being subject to current “gun-jumping” restrictions on pre-offering communications.

Investment banks are permitted to publish or distribute research reports about an emerging growth company that proposes to file a registration statement or is in registration even if the investment bank is participating or will participate in the offering.

Phased-in Reporting Requirements for Registered Emerging Growth Companies

Once an EGC has conduced an IPO, the JOBS Act allows for a phase-in of certain regulations, including certain provisions of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, over up to a five-year period. Specifically, while a company is classified as an EGC, it is not subject to:

- required auditor attestation of internal controls under Section 404(b) of the Sarbanes-Oxley Act (however, the CEO and CFO of an emerging growth company will still be responsible for establishing and maintaining internal controls over its financial reporting and certifying to those internal controls in its periodic filings);
- any new or revised financial accounting standard until the date on which such accounting standard becomes broadly applicable to private companies; or
- the requirement added by the Dodd-Frank Act to seek annual approval of executive compensation, commonly referred to as a “say-on-pay” vote, in proxy or consent materials, and to disclose the relationship between executive compensation and company performance and the ratio of CEO pay to median employee pay;
- compliance with mandatory audit firm rotation under PCAOB rules.

The JOBS Act also requires the SEC to conduct a review of Regulation S-K (the SEC regulation that lays out reporting requirements for various SEC filings used by public companies) and to report to Congress within 180 days following the enactment of the JOBS Act with rule-making proposals to modernize and simplify the registration and reporting process and reduce the costs and other burdens of these rules for EGCs.

Increase in Maximum Aggregate Offering Amount under Regulation A

The JOBS Act permits the SEC to amend Regulation A to, among other things, increase the aggregate offering amount of securities offered and sold within any 12-month period in reliance on such exemption from $5 million to $50 million.

Regulation A offerings are exempt from registration under Section 5 of the Securities Act; however, issuers are required to file an offering statement with the SEC. Securities sold under Regulation A are not subject to the restriction on general solicitation and advertising, which means that such securities may be publicly offered. Further, securities sold under Regulation A are not restricted securities, meaning they are freely tradable in the secondary market.

Despite the benefits of Regulation A, the Regulation A exemption has rarely been used by issuers, as most issuers prefer to utilize Rule 506. Increasing the maximum offering amount under Regulation A may increase utilization of the exemption; however, securities offered under Regulation A are not “federally covered securities” and are therefore subject to various state Blue Sky laws and regulations, which may also explain Regulation A’s unpopularity. The JOBS Act directs the U.S. Comptroller General to conduct a study on the impact of state Blue Sky laws on offerings made under Regulation A, and to submit a report on the study to the relevant House and Senate Committees not later than three months after enactment.

Increase in Shareholder Cap for Triggering Reporting Under Section 12(g) of the Exchange Act

Section 12(g)(1) of the Exchange Act currently requires an issuer that has a class of equity security held of record by 500 or more persons to register that security with the SEC within 120 days after the last day of its first fiscal year in which the issuer had total assets exceeding $10,000,000. For issuers other than banks or bank holding companies, the JOBS Act raises the record holder threshold for registration to either (i) 2,000 persons or (ii) 500 persons who are not accredited investors. For banks and bank holding companies the threshold is 2,000 persons.

The JOBS Act also amends provisions of the Exchange Act that permit termination of registration and suspend periodic reporting obligations of securities held of record by less than 300 persons, by increasing the threshold to 1,200 persons for securities of a bank or bank holding company.

The JOBS Act also provides that, for all issuers, persons holding securities received under an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act (for example, because they were issued in a private placement under Regulation D or under Rule 701 under the Securities Act) will be excluded from the record holder count.

A Senate amendment that would have changed the way the SEC counts the number of shareholders for purposes of determining the threshold under Section 12(g) was not adopted.

If you have any questions or concerns as to how the JOBS Act will affect you or your business, or are interested in raising capital for your business or new venture through a public or private offering of securities, or if you have any questions about corporate and securities laws or the capital raising process in general, please contact any one of the attorneys listed in this Client Alert.