House Passes Capital Access Reform Legislation

March 12, 2012

On March 8, 2012, the U.S. House of Representatives passed the Jumpstart Our Business Startups Act (the "JOBS Act") in a 390-23 vote reflecting bipartisan support for the legislation. The JOBS Act is intended to (1) encourage initial public offerings by "emerging growth companies" and (2) facilitate the ability of companies to raise capital in private and small public offerings without registration with the Securities and Exchange Commission.

IPO ON-RAMP

The JOBS Act contains significant reforms to the initial public offering process for emerging growth companies, which is defined to include a large number of companies currently seeking to go public in the United States, and exempts these companies from a number of disclosure and other requirements for up to five years following their IPOs.

Definition of Emerging Growth Company. The Act defines an "emerging growth company" as any issuer with less than $1 billion in revenues in its last fiscal year. A company would continue to qualify as an emerging growth company until the earliest of (1) the end of the fiscal year in which revenues exceed $1 billion, (2) the end of the fiscal year following the fifth anniversary of its IPO, (3) the date on which it has issued more than $1 billion in non-convertible debt in a three-year period or (4) the date it becomes a "large accelerated filer" (which currently includes seasoned issuers with a worldwide public float of $700 million or more).

IPO Process Reforms. The Act would (1) reduce the amount of historical financial information an emerging growth company is required to include in the registration statement for its IPO, (2) provide for confidential SEC review of such registration statement, (3) permit additional communications by or on behalf of these companies with institutional investors and (4) reduce restrictions governing the publication of reports with respect to these companies by securities analysts.

- *Two Years of Financial Information* — An emerging growth company would not need to present more than two years of audited financial statements or selected financial data in the registration statement for its IPO.

- *Confidential Review* — An emerging growth company would be entitled to confidential nonpublic review by the staff of the SEC of the registration statement for its IPO, similar to the process that was historically available to foreign issuers in relation to their initial registrations with the SEC,[1] although the initial confidential

[1] The staff of the SEC took action in December 2011 to curtail the confidential review process as it relates to foreign private issuers.

submission and all amendments would need to be publicly filed at least 21 days prior to the start of an emerging growth company's roadshow.

- *Communications with Institutional Investors* —An emerging growth company or any person authorized to act on its behalf would be permitted to communicate (orally or in writing) before or after filing or effectiveness of a registration statement with potential investors that are qualified institutional buyers or institutional accredited investors to solicit interest in connection with a contemplated securities offering.

- *Analyst Reports* —Publication or distribution by a broker or dealer of research reports about an emerging growth company subject to a proposed public offering, whether before or after the registration statement has been filed or become effective, would not constitute an offer for sale even if the broker or dealer is participating or will participate in the offering. Rules limiting the ability of a broker or dealer to publish reports about an emerging growth company during the customary lockup or other post-IPO period would also be relaxed. The legislation would also make it easier for analysts and issuers to communicate by removing restrictions on who may arrange for communications between securities analysts and investors and to permit securities analysts to participate in communications with an emerging growth company's management alongside other representatives of a broker or dealer. Analyst reports would still be subject to other restrictions, such as the conflict of interest rules relating to securities analysts under Section 501 of the Sarbanes-Oxley Act.

Reduced Ongoing Requirements. Emerging growth companies would be relieved of a number of disclosure and financial reporting obligations:

- *Auditor Attestation* —Auditors of an emerging growth company would not need to attest to its internal controls under Section 404(b) of the Sarbanes-Oxley Act, although emerging growth companies would still be required to establish and maintain internal controls and include CEO and CFO certifications in accordance with current law. This exemption would continue to be available for up to five years after the IPO as long as the issuer continues to qualify as an emerging growth company, in contrast to the current requirement that generally requires companies with a worldwide public float of $75 million or more to include an auditor attestation in the second annual report on Form 10-K they file after going public.

- *Public Company Accounting Standards* —Emerging growth companies would not be required to comply with a financial accounting standard until such standard is generally applicable to companies that are not "issuers" under the Sarbanes-Oxley Act. While an emerging growth company would generally be permitted to choose whether or not to rely on any particular available exemption, it would not be

permitted to pick and choose which public company accounting standards would apply. Instead, each emerging growth company would need to make an all-or-nothing election with respect to this exemption that would continue for so long as it is an emerging growth company.

- *Audit Rules* —Any rules requiring mandatory audit firm rotation and auditor discussion and analysis that may be adopted by the SEC would not apply to emerging growth companies, nor would and any future audit rules promulgated by the Public Company Accounting Oversight Board (unless the SEC otherwise determines).

- *Say-on-Pay* —An emerging growth company would not be required to hold a shareholder vote on executive compensation, including golden parachutes, until one to three years after it ceases to be an emerging growth company.

- *Executive Compensation Disclosure* —Requirements to disclose a comparison of executive compensation to company performance and a ratio of CEO to worker pay would not apply to emerging growth companies.

OTHER CAPITAL ACCESS REFORMS

In addition to the IPO on-ramp provisions, the JOBS Act includes a number of other reforms that expand opportunities for companies to raise capital in private and small public offerings without triggering SEC registration requirements under the Securities Act of 1933 or the Securities Exchange Act of 1934.

- *General Solicitation in Reg D and Rule 144A Sales* — General solicitation or general advertising would be permitted in connection with the private sale of securities exclusively to accredited investors under Rule 506 of Regulation D or exclusively to qualified institutional buyers under Rule 144A, as long as the issuer or seller took reasonable steps to verify the accredited investor or QIB status of the purchasers.

- *Crowdfunding* — Companies would be permitted to raise limited amounts of capital from a large pool of small investors without registration under federal or state securities laws. Any issuer could raise up to $1,000,000 in any twelve-month period (or $2,000,000 if audited financial statements are provided to investors). However, the amount of securities sold to each investor in any twelve-month period would be capped at the lesser of 10% of that investor's annual income or $10,000. In order to qualify for the exemption, the issuer and any intermediary would need to meet disclosure, operational and filing requirements.

- *"Small" Issues Under Regulation A* —The SEC would be required to amend Regulation A, the conditional exemption for small issues, to increase the amount of unrestricted

debt, equity or convertible debt securities companies are permitted to publicly offer and sell in any twelve-month period without registration under federal securities laws from $5 million to $50 million. Unlike offerings exempted under the crowdfunding provisions described above, these offerings would still be subject to state securities laws, unless the securities are offered or sold on a national securities exchange or sold only to qualified purchasers. The offering would also need to comply with regulations to be promulgated by the SEC, including the filing of an offering memorandum containing required disclosures. An issuer relying on this new exemption would also need to annually file audited financial statements and such other periodic disclosures as the SEC may determine.

- *Shareholder Caps*—The number of shareholders that a private company may have before it is required to register under the Securities Exchange Act would be raised to 2,000 shareholders of record, so long as no more than 499 shareholders are not accredited investors. (Currently, a company is required to register once it has $10,000,000 in assets and at least 500 shareholders of record.) In addition, the modified cap would exclude any shareholders who received their securities pursuant to an employee compensation plan or as part of the new crowdfunding exemption described above. A similar change would raise the shareholder cap applicable to banks and bank holding companies to 2,000, without further limiting shareholders that are not accredited investors.

NEXT STEPS

The JOBS Act has been forwarded for consideration by the U.S. Senate, which has already been considering its own capital access reform legislation. The Senate Majority Leader, Harry Reid, called the House passage "commendable" and indicated the Senate would quickly introduce their own bill, which would be "different than" but "in the same framework" as the House bill. The White House has indicated that President Obama's administration "looks forward to continuing to work with the House and the Senate to craft legislation that facilitates capital formation and job growth for small businesses and provides appropriate investor protections." An SEC spokesperson said that "[i]t is critical that the final bill contains sufficient investor protections, and the SEC will continue to work with Congress to that end."

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