Congress Adopts Capital Access Reform

March 27, 2012

The U.S. Congress today passed The Jumpstart Our Business Startups Act (the "JOBS Act"), a package of capital access reforms 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. The JOBS Act passed the Senate by a vote of 73-26 and the House of Representatives by a vote of 380-41 and President Obama is expected to sign the legislation into law shortly. The legislation passed by Congress is identical to the version initially passed by the House on March 8, with the exception of the provisions relating to "crowdfunding," which were amended to provide for additional investor protections.

Certain provisions of the JOBS Act – such as the "IPO on-ramp" provisions and the increase in the number of shareholders a company can have before it must register under the Securities Exchange Act of 1934 – will become operative as soon as the legislation is signed into law by the President, although conforming and implementing rulemaking by the Securities and Exchange Commission is contemplated and the ability of market participants to take full advantage of aspects of the reforms may depend upon such rulemaking and/or additional guidance from the SEC staff. Other provisions of the JOBS Act – such as those eliminating (subject to certain conditions) the prohibition against general solicitation or advertising in Rule 506 of Regulation D and Rule 144A, those relating to "crowdfunding" and those allowing unregistered public offerings up to $50 million pursuant to Regulation A – will require implementing SEC rulemaking before they become operative.

IPO ON-RAMP

The JOBS Act contains significant reforms to the initial public offering process for "emerging growth companies" 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. An "emerging growth company" is defined as any issuer with less than $1 billion in revenues in its last fiscal year, a threshold which would have covered a significant majority of companies that went public in the United States over the past several years. An issuer will continue to qualify as an emerging growth company until the earliest of (1) the end of the fiscal year in which its 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). An issuer that first sold securities in its IPO on or prior to December 8, 2011 will not qualify as an emerging growth company.

IPO Process Reforms. The reforms (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 will 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 will be entitled to confidential nonpublic review by 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 submission and all amendments will 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 will 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 determine whether such investors might have an interest in 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, will 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 or immediately after the customary lockup or other post-IPO period will also be relaxed. The legislation will 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 permitting securities analysts to participate in communications with an emerging growth company's management alongside other representatives of a broker or dealer. (Analyst reports will remain subject to other restrictions, such as the conflict of interest rules relating to securities analysts under Section 501 of the Sarbanes-Oxley Act.)

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1 The staff of the SEC took action in December 2011 to curtail the confidential review process as it relates to foreign private issuers. It currently appears that under this legislation foreign private issuers will once again be able to receive a confidential review to the extent they qualify as emerging growth companies.

Reduced Ongoing Requirements. The reforms also relieve emerging growth companies from a number of disclosure and financial reporting obligations:

- *Auditor Attestation* — Auditors of an emerging growth company will not need to attest to its internal controls under Section 404(b) of the Sarbanes-Oxley Act, although emerging growth companies will still be required to establish and maintain internal controls and include CEO and CFO certifications in accordance with current law. This exemption will 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 will 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 will generally be permitted to choose whether or not to rely on any particular available exemption, it will not be permitted to pick and choose which public company accounting standards would apply. Instead, each emerging growth company will need to make an all-or-nothing election with respect to this exemption that will 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 Public Company Accounting Oversight Board will not apply to emerging growth companies. Nor, unless the SEC otherwise determines, will any future audit rules promulgated by the Public Company Accounting Oversight Board.

- *Say-on-Pay* — An emerging growth company will 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* — Emerging growth companies will be permitted to disclose executive compensation in the same manner as "smaller reporting companies," which generally are only required to disclose the compensation of three (rather than five) executive officers and are not required to present a "compensation discussion and analysis." Emerging growth companies will also not be required to disclose a comparison of executive compensation to company performance or a ratio of CEO to worker pay.

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 will 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 takes reasonable steps to verify the accredited investor or QIB status of the purchasers.

- *Crowdfunding*— Private companies will be permitted to raise limited amounts of capital from a large pool of small investors without registration under federal or state securities laws, by using an SEC-registered broker or a newly created class of SEC-registered funding portals to "crowdfund." A private company may raise up to $1,000,000 in any twelve-month period by issuing restricted securities. However, the aggregate amount that each individual may invest will be capped at amounts ranging from $2,000 to $100,000, depending on each investor's annual income and net worth.[2] Both the issuer and intermediary will need to meet a number of one-time and ongoing requirements in order to rely upon the crowdfunding exemption. In addition, issuers, executives and directors will be liable to the purchasers of these securities, who may sue either for damages or a full refund based on any material misstatements or omissions.

- *"Small" Issues Under Regulation A*—The SEC will be required to amend Regulation A (the conditional exemption for small issues) or adopt a new regulation to increase from $5 million to $50 million 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. Unlike offerings exempted under the crowdfunding provisions described above, these offerings will 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. Among other requirements, the offering will also need to comply with regulations to be promulgated by the SEC, including the filing of an offering memorandum containing required disclosures. An

[2] The cap for each investor during any twelve month period is (a) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable (if either the annual income or the net worth of the investor is less than $100,000); and (b) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000. This is an aggregate cap that includes all purchases of crowdfunded securities, regardless of issuer.

issuer relying on this new exemption will 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 will 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 will exclude any shareholders who received their securities pursuant to an employee compensation plan and the SEC will be required to exempt by rule securities received as part of the new crowdfunding exemption described above. A similar change will raise the shareholder cap applicable to banks and bank holding companies to 2,000, without further limiting the number of shareholders that are not accredited investors.

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