

Corporate Alert

Congress Passes Legislation Easing IPO Process and Private Capital Formation

March 28, 2012

On March 27, 2012, Congress approved the Jumpstart Our Business Startups Act (the “JOBS Act”). The legislation, which is expected to be signed into law shortly by President Obama, is designed to help smaller companies access the capital markets by easing private capital formation and reducing certain regulatory requirements for smaller companies going public. Among other things, the JOBS Act—

- creates a new category of issuer, called an “emerging growth company,” for companies with less than \$1 billion in annual gross revenue
- eases the IPO process for such companies and reduces their reporting and disclosure obligations for up to five years post-IPO
- permits advertising and general solicitation in Regulation D offerings so long as all purchasers are accredited investors and in Rule 144A offerings so long as all purchasers are qualified institutional buyers
- adds a new Regulation A-style exemption for offerings of up to \$50 million and exempts some of these offerings from state blue sky laws
- raises the threshold requiring registration by companies under the Securities Exchange Act of 1934 to 2,000 holders of record (of which only 499 can be non-accredited investors)
- allows non-reporting companies to use “crowdfunding” to raise up to \$1 million in any 12-month period, subject to certain conditions.

Emerging Growth Companies

The JOBS Act eases some of the initial public offering requirements for companies with less than \$1 billion in annual revenues and also reduces their reporting and disclosure obligations for up to five years post-IPO.

Definition of Emerging Growth Company. An emerging growth company is defined as an issuer with total annual gross revenues of less than \$1 billion during its most recently completed fiscal year, other than any such issuer whose IPO¹ occurred on or before December 8, 2011. Consequently, companies that went public after December 8, 2011, but before the JOBS Act effective date, may qualify as emerging growth companies and enjoy the benefits of the lighter regulatory burden imposed on such companies.

¹ For purposes of the JOBS Act, the date of a company’s initial public offering is defined as the date of the first sale of its common equity securities pursuant to an effective registration statement under the Securities Act.



An emerging growth company will lose its status as such on the earliest of—

- the last day of the fiscal year in which the company had \$1 billion or more in annual gross revenues
- the last day of the fiscal year following the fifth anniversary of the company's IPO
- the date on which the company has, during the previous three-year period, issued more than \$1 billion in non-convertible debt
- the date on which the company is deemed a "large accelerated filer."²

Reduced Registration and Disclosure Requirements. Emerging growth companies will be subject to less stringent registration requirements under the Securities Act of 1933 (the "*Securities Act*") and reduced disclosure requirements under the Securities Exchange Act of 1934 (the "*Exchange Act*") as follows—

- *Only two years of audited financial statements required for IPO.* An emerging growth company need include in the registration statement for its IPO only two (rather than three) years of audited financial statements. In any other registration statement under the Securities Act, an emerging growth company need not present selected financial data for any period prior to the earliest audited period presented in its initial public offering, and with respect to any registration statement or periodic or other report filed under the Exchange Act, need not present selected financial data for any period prior to the earliest audited period presented in its first registration statement that became effective under the Securities Act or the Exchange Act. An emerging growth company is required to include MD&A discussion only for the periods for which financial statements are presented.
- *Confidential submission of IPO registration statement.* Prior to the date of its IPO, an emerging growth company can submit a draft registration statement to the SEC for confidential review. However, the initial confidential submission and all amendments thereto must be publicly filed at least 21 days before the road show for the offering.
- *Permitted pre-offering communications with QIBs and accredited investors.* Emerging growth companies and persons acting on their behalf may "test the waters" by communicating with qualified institutional buyers or institutions that are accredited investors to determine whether such investors might have an interest in a contemplated securities offering. These communications can be oral or written and can occur before or after the filing of a registration statement.
- *Expansion of permitted analyst communications during offering.* The JOBS Act promotes research reports on emerging growth companies. As such, the publication or distribution of research reports about an emerging growth company that is the subject of a proposed public offering of its common equity securities pursuant to a registration statement that the company proposes to file or has filed, or that has become effective, will not be deemed an "offer" for purposes of Securities Act Section 5(c) (which prohibits offers of securities unless a registration statement is on file) or Section 2(a)(10) (which defines prospectus), under the Securities Act, regardless of whether the broker or dealer is participating or will participate in the registered offering. The JOBS Act also prohibits the SEC and any national securities association from adopting or maintaining rules that—
 - in connection with an IPO for an emerging growth company, (i) restrict, based on functional role, which associated persons of a broker, dealer or national securities association member may arrange for

² A large accelerated filer is an issuer that meets the following conditions as of the end of a fiscal year: (1) the issuer had an aggregate worldwide market value of voting and non-voting common equity held by non-affiliates of \$700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter, (2) the issuer has been subject to the Exchange Act's reporting requirements for a period of at least 12 calendar months, (3) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act, and (4) the issuer is not eligible to use the disclosure requirements for smaller reporting companies in its annual and quarterly reports.

communications between a securities analyst and a potential investor or (ii) restrict a securities analyst from participating in communications with an emerging growth company's management that is also attended by any other associated person who is functioning other than as a securities analyst; or

- prohibit any broker, dealer or national securities association member from publishing or distributing research reports, or making public appearances, regarding an emerging growth company during any particular post-IPO period or lock-up period.
- *Exemption from new or revised accounting standards.* Under both the Securities Act and the Exchange Act, emerging growth companies do not have to comply with any new or revised financial accounting standards until such date such standards are also applicable to private companies.
- *No auditor attestation on internal controls.* Emerging growth companies are exempt from the requirement in Section 404(b) of the Sarbanes-Oxley Act of 2002 to obtain an auditor attestation regarding the adequacy of the company's internal control over financial reporting.
- *Exemption from future PCAOB rules mandating auditor rotation or making modifications to the auditor report.* Emerging growth companies do not have to comply with any rules adopted in the future by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (an auditor discussion and analysis).³ Also, any additional rules adopted by the PCAOB after the JOBS Act's enactment date will not apply to emerging growth companies unless the SEC determines that their application is necessary or appropriate.
- *No Say-on-Pay Vote.* Emerging growth companies do not have to give shareholders a vote on executive compensation. Once a company ceases to be an emerging growth company, there is a phase-in period for the say-on-pay vote: for a company that was an emerging growth company for less than two years, the say-on-pay resolution must be included in the company's proxy statement not later than the third anniversary of the date of its IPO; and for a company that has been an emerging growth company for at least two years, the say-on-pay resolution must be included in the company's proxy statement within one year of the date the company ceased to be an emerging growth company. Emerging growth companies are also exempt from the requirement to give shareholders an advisory vote on golden parachute arrangements.
- *Reduced Executive Compensation Disclosure.* Emerging growth companies can comply with the executive compensation disclosures required under Item 402 of Regulation S-K by providing the same level of information required of smaller reporting companies.⁴ Also, emerging growth companies will not be required to provide a comparison of executive pay to the company's financial performance or a comparison of executive pay to the median pay of all other employees.⁵
- *Right to Opt-In.* An emerging growth company can elect to forego any of the foregoing exemptions and instead comply with the same requirements that apply to other public companies. However, if an emerging growth company chooses to comply with accounting standards that do not apply to emerging growth companies, the company must notify the SEC and make its choice at the time it is first required to file a registration statement or periodic or other report under Section 13 of the Exchange Act, and it must continue to comply with such standards as long as the company remains an emerging growth company. In addition, an emerging growth company so

³ The PCAOB has issued concept releases on these items, but has not yet adopted rules implementing these requirements.

⁴ A smaller reporting company, in general, is an issuer with a public float of less than \$75 million, or if the issuer has no public float, with annual revenues of less than \$50 million. Smaller reporting companies (1) are not required to include a Compensation Discussion and Analysis, (2) must provide information on only three (rather than five) named executive officers, (3) must include only three (rather than seven) compensation tables, and (4) must provide only two (rather than three) years of compensation in the Summary Compensation Table.

⁵ Disclosure of these comparisons by public companies is mandated under the Dodd-Frank Act, but the SEC has not yet adopted rules implementing these requirements.

electing cannot pick and choose which accounting standards apply to it and instead must comply with all accounting standards to the same extent that a non-emerging growth company is required to comply.

Advertising in Regulation D and Rule 144A Offerings

The JOBS Act requires the SEC, within 90 days after the enactment date of the Act, to revise Regulation D to provide that the current prohibitions against general solicitation or general advertising contained in Rule 502(c) do not apply to offers and sales of securities made pursuant to Rule 506 (which applies to offerings without regard to dollar amount) provided that all purchasers of the securities are accredited investors. The revised rules must require the issuer to take reasonable steps to verify that the purchasers are accredited investors according to such methods as determined by the SEC. Within the same 90 days, the SEC must make similar changes to Rule 144A to provide that securities sold under the rule may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided the securities are ultimately sold to only persons the seller and any person acting on its behalf reasonably believe are qualified institutional buyers.

The JOBS Act also amends Section 4 of the Securities Act to expressly provide that offers and sales made pursuant to revised Rule 506 will not be deemed public offerings under the federal securities laws as a result of general advertising or general solicitation. Consequently, Rule 506 offerings by funds relying on the exclusions from being considered an “investment company” set forth in Sections 3(c)(1) and 3(c)(7) under the Investment Company Act should enjoy the benefits of the new general solicitation provisions.

The JOBS Act also provides that a person is not required to register as a broker or dealer with respect to a Rule 506 offering solely because the person maintains a trading platform with respect to securities, permits general solicitations or advertisements or engages in certain ancillary services so long as, among other things, neither such person nor any associated person (i) receives any compensation in connection with the purchase or sale of such securities or (ii) possesses customer funds or securities in connection with the transaction. This provision helps clarify the requirements that must be satisfied by online platforms and other matching services to avoid broker-dealer registration.

New Regulation A-Style Exemption for Offerings of Up to \$50 Million

Section 3(b) of the Securities Act allows the SEC to exempt from the Securities Act’s registration requirements offerings of up to \$5 million. Pursuant to this provision, the SEC has promulgated Regulation A, which allows a non-reporting issuer relying on the exemption to raise up to \$5 million during any 12-month period. Securities issued in a Regulation A offering are not restricted securities. The JOBS Act adds an additional exemption to Section 3(b) for offerings of up to \$50 million, subject to certain conditions. The JOBS Act also exempts offerings made in reliance on the new exemption from state securities laws relating to registration, documentation and offering requirements if the securities are offered and sold on a national securities exchange or sold to “qualified purchasers,” as defined by the SEC. The higher offering cap and the exemption from state blue sky laws should increase the appeal of the Section 3(b) offering exemption for smaller companies, particularly for smaller companies that want to avoid the costs of a registered offering but not be constrained by the purchaser limitations of Regulation D.

Under amended Section 3(b) of the Securities Act, the SEC is required to adopt rules or regulations exempting securities from the registration requirements of the Securities Act in accordance with the following—

- the aggregate amount of all securities offered and sold in reliance on the exemption within a 12-month period does not exceed \$50 million
- the securities must consist of equity securities, debt securities or debt securities convertible or exchangeable for equity interests, including any guarantees of such securities
- the securities can be offered and sold publicly, and the securities will not be considered restricted securities

- the SEC may impose such additional terms on the offering as it prescribes, including the requirement that issuers file with the SEC and distribute to investors an offering statement
- subject to such rules as the SEC may adopt, the issuer may solicit interest in a securities offering prior to filing the offering statement with the SEC
- the issuer must file with the SEC annual audited financial statements and such other periodic filings as the SEC may require
- certain “bad actors” will not be eligible to use the exemption⁶
- the civil liability provision in Section 12(a)(2) shall apply to any person offering or selling such securities.

Higher Threshold for Exchange Act Registration

The JOBS Act raises the number of shareholders a company can have before it is required to register a class of equity securities with the SEC under Section 12(g) of the Exchange Act.⁷ Under the new threshold, a company must register a class of equity securities within 120 days after the last day of its first fiscal year on which the company has more than \$10 million in total assets and a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors. Previously, the number of record holders that would trigger the registration requirement was 500. In determining the number of record holders, securities held by persons who received the securities under an equity compensation plan in a transaction exempt from the registration requirements of the Securities Act are not counted. In addition, the SEC is required to adopt rules conditionally or unconditionally, excluding securities acquired in an exempt crowdfunding transaction, as discussed below, from the determination of the number of record holders.

Crowdfunding

The JOBS Act amends the Securities Act by adding a new Section 4(6) that exempts certain crowdfunding offerings from the registration requirements of the Securities Act. Crowdfunding, which has become popular in recent years with the growth in social media, typically involves raising funds for a common cause or venture through small contributions from many individuals. The new exemption would allow a non-reporting issuer to raise up to \$1 million in any 12-month period in reliance on the exemption. To qualify for the exemption, several conditions must be satisfied:

- *Cap on amount raised.* The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction, cannot exceed \$1 million.
- *Cap on individual investments.* The aggregate amount that can be sold to any investor during the 12-month period cannot exceed—
 - the greater of \$2,000 or 5 percent of the annual income or net worth, as applicable, of an investor whose annual income or net worth is less than \$100,000; or

⁶ Felons and other categories of “bad actors” will be disqualified in accordance with rules to be adopted by the SEC. The disqualification provisions must be similar to those that the SEC is required to adopt for Regulation D offerings pursuant to Section 926 of the Dodd-Frank Act. The SEC has proposed, but not yet adopted, the disqualification provisions for Regulation D.

⁷ The JOBS Act also raises the threshold for registration under Section 12(g) by banks and bank holding companies to 2,000 holders of record. Also, a bank or bank holding company will cease to be subject to Exchange Act reporting if its shareholder base falls below 1,200 record holders.

- 10 percent of the investor’s annual income or net worth, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the investor’s annual income or the investor’s net worth is \$100,000 or more.
- *Required use of broker or funding portal.* The transaction must be conducted through a broker or funding portal that complies with the exemption’s requirements. A funding portal is defined as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others solely pursuant to Section 4(6) that does not offer investment advice or recommendations; solicit purchases or sales of securities offered or displayed on its website or portal; compensate employees, agents or others for such solicitation; or possess or otherwise handle investor funds or securities.

A broker or funding portal acting as an intermediary in a Section 4(6) transaction must, among other things—

- be registered with the SEC and any applicable self-regulatory organization
- provide such disclosures to investors as the SEC may prescribe, including disclosures relating to risks and other investor education materials, and ensure that investors review the disclosures, answer various questions and affirm risk of loss
- perform background and regulatory checks on the issuer’s officers, directors and major shareholders
- make certain information provided by the issuer available to investors and the SEC at least 21 days before the day on which securities are sold
- ensure that all offering proceeds are provided to the issuer only when the target offering amount is reached
- protect investor privacy and not compensate promoters, finders or lead generators for providing personal identifying information about potential investors
- prohibit its directors, officers or partners from having any financial interest in an issuer using its services
- make such efforts as the SEC determines to ensure that no investor in a 12-month period has purchased securities pursuant to Section 4(6) that, in the aggregate, from all issuers, exceed the investment limits set forth above.
- *No issuer advertising.* The issuer cannot advertise the terms of the offering, except for notices directing investors to the funding portal or broker.
- *Disclosure document.* The issuer must file with the SEC and provide to investors and the broker or funding portal certain information, including information about—
 - the issuer, its officers, directors and major shareholders, as well as a description of the issuer’s business, business plan, capital structure and financial condition (including audited financial statements for offerings of more than \$500,000 or such other amount as the SEC may require)
 - the offering, including its purpose, the target offering amount, the deadline to reach such amount, the offering price and risks to purchasers, as well as such additional information as the SEC may prescribe.
- *No undisclosed offering compensation.* The issuer cannot compensate any person to promote its offerings through communication channels provided by a broker or funding portal, unless such compensation is clearly disclosed in accordance with such rules that the SEC may require.

- *Annual reporting.* The issuer must file with the SEC and provide to investors annual reports of its results of operations and financial statements.

Crowdfunding offerings meeting the requirements of the exemption will be exempt from state blue sky regulation relating to registration, documentation and offering requirements. Securities issued in a Section 4(6) transaction may not be transferred for one year after purchase, unless they are registered or are transferred to the issuer, an accredited investor or a family member, or in connection with the purchaser's death or divorce, and subject to such other restrictions as the SEC may impose.

The Section 4(6) exemption is available for only domestic companies that are neither reporting companies under the Exchange Act nor investment companies. In addition, certain "bad actors" (who will be substantially similar to those disqualified under Regulation A) will not be eligible for the exemption.

A company issuing securities in reliance on the crowdfunding exemption will have the same liability as if Section 12(a)(2) of the Securities Act applied. For purposes of the liability provision, an "issuer" is broadly defined to include directors, partners and officers of an issuer and any person who offers or sells the securities in the offering.

The SEC is required to issue rules implementing Section 4(6) within 270 days after the enactment date of the JOBS Act.

Conclusion

The stated purpose of the JOBS Act is to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." By raising the cap on Section 3(b) exempt offerings, easing the IPO process and increasing the threshold for Exchange Act registration, the new law should facilitate capital raising by smaller companies. In addition, all companies should benefit from the lifting of the ban on advertising in Regulation D and Rule 144A offerings.

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