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JOBS Act Targets Smaller Business Capital Raising

by Louis A. Bevilacqua, Joseph R. Tiano, Jr., David S. Baxter, Ali Panjwani and K. Brian Joe

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act), a bill with widespread bipartisan support and assembled from a combination of legislative initiatives introduced throughout 2011 targeting smaller companies and focusing on cheaper capital raising and job creation. We discuss the key provisions of the JOBS Act and their impact on these companies and securities offerings.

The Jumpstart Our Business Startups Act (JOBS Act) is a consolidation of several bills introduced throughout 2011[1] with the goal of making it easier for smaller companies to raise money and lessen their regulatory burden while doing so. The House of Representatives passed the JOBS Act on March 8 by a vote of 390-23, and the Senate passed the same bill, with one amendment, on March 22 by a vote of 73-26. The Senate amendment offered a more restrictive take on the House bill's provisions dealing with the increasingly popular grass-roots financing method known as crowdfunding. On reconsideration of the bill with the Senate amendment, the JOBS Act passed the House by a vote of 380-41 on March 27, and President Obama signed it into law on April 5.

The JOBS Act is one of the most comprehensive pieces of legislation in recent years to be specifically targeted at developing companies. This Alert summarizes the most important provisions of the JOBS Act and the implications of those provisions.

General Advertising Restrictions Lifted Under Regulation D and Record Holder Threshold Increased

The JOBS Act mandates the Securities and Exchange Commission (SEC) to revise Regulation D under the Securities Act of 1933 to permit general solicitation and general advertising in private placements made under Rule 506 under the Securities Act, so long as each purchaser of the issuer's securities meets the definition of an "accredited investor" under the Securities Act. We believe that this change to Rule 506

[1] A review of these bills can be found in the prior Pillsbury publication titled "Crowdfunding and Other Recent Legislative Initiatives Focused on Capital Raising and Job Creation" located at http://www.pillsburylaw.com/index.cfm?pageid=34&itemid=40443.

will be the most meaningful change to the securities offering process that comes out of the JOBS Act. Previously, private companies wishing to solicit prospective investors without registration with the SEC were limited to making offers to those with whom they have a pre-existing relationship or with whom a broker-dealer they engage has a pre-existing relationship. An issuer may now seek out investors that are accredited investors or qualified institutional buyers (QIBs) by engaging in general solicitation and public advertising, including through use of the internet and social media, thereby significantly increasing the universe of prospective investors, all without having a registration statement on file with the SEC.[2] It was already the case that securities offered under Rule 506 are "covered securities" under NSMIA and therefore exempt from substantive state regulation, and are not reviewed by the SEC (unlike Regulation A offerings). It therefore is likely that, as the JOBS Act dramatically increases the attractiveness and opportunities for unregistered offerings, Rule 506 will remain the dominant choice for all unregistered offerings.

Another significant feature of the JOBS Act is that it raises the threshold for mandatory registration under Section 12(g) of the Securities Exchange Act of 1934 from 500 to 2,000 shareholders of record (as long as the company does not have 500 shareholders of record who are not accredited investors, in which case the 500-shareholder limit effectively remains). (We anticipate that the SEC and issuers will have substantial difficulty determining whether shareholders of record are accredited investors, as many issuers do not even know the identity of most of their shareholders.) Shareholders "of record" now exclude crowdfunding investors (described below) and persons who receive securities pursuant to employee compensation plans that are exempt from registration under the Securities Act (which is consistent with the SEC's no-action position permitting private companies to exclude holders of stock options when determining whether they have 500 holders). The 2,000-holder rule will give many private companies more control over whether and when they wish to become a public company and can forestall the associated time, expense and regulatory burden associated with becoming a public company.

Taken together, these changes to Regulation D and Section 12(g) may result in very large Regulation D offerings becoming increasingly common. With the mandatory 1934 Act registration limit increased to 2,000 holders, it will be easier for many companies to stay private longer. Aside from ease of process, Rule 506 offerings have had the added attraction, since the Supreme Court's decision in *Gustafson v. Alloyd Co.*, that no private cause of action for negligent misrepresentation is available to disappointed investors. Many private issuers are likely to see Regulation D as a very attractive financing option, given the ability to canvass a wide swath of QIBs and other accredited investors, the absence of any limitation on offering size or number of investors, the absence of SEC review of substantive disclosure, the absence of state regulation and the absence of private causes of action for negligent misrepresentation.

"IPO On Ramp" and "Emerging Growth Companies"

The JOBS Act provides an "IPO on ramp" for "emerging growth companies" (a newly created category of issuer under the Securities Act), which are issuers with annual gross revenues of less than $1 billion during the most recently completed fiscal year. Emerging growth companies may take advantage of the scaled disclosure requirements that already have been available to "smaller reporting companies" (defined by the Securities Act as companies having a public float of less than $75 million). The scaled disclosure includes a requirement to include only two, rather than three, years of audited financial statements in the issuer's initial public offering (IPO) registration statement and, during the "IPO on ramp" period, the ability to omit the auditor's attestation on internal control over financial reporting required by the Sarbanes-Oxley

[2] Because issuers would be required to "verify" the accredited status of their investors, we may see the return of detailed investor questionnaires common in the mid-1980s, requiring a summary statement of the potential investor's assets and liabilities.

Act of 2002.[3] Also during the "IPO on ramp" period, emerging growth companies would not need to submit say-on-pay votes to their stockholders (including say-on-pay frequency or golden parachute votes) and would face more limited executive compensation disclosure requirements than larger companies.

Changes to the IPO process itself are likely the most significant aspects of the new emerging growth company regime. The JOBS Act allows an emerging growth company to submit its IPO registration statement on a confidential basis, with the result that any sensitive information contained in the registration statement would not be immediately publicly available. The ability for an emerging growth company to maintain confidentiality and avoid disclosing that it is contemplating an offering until it is ready to do so is significant. However, the initial confidential submission and any subsequent amendments must be publicly filed at least 21 days before the issuer's road show. In addition, the JOBS Act permits an emerging growth company to "test the waters" by communicating orally or in writing with QIBs or other accredited investors to gauge interest in a contemplated securities offering, even if a registration statement has not yet been filed, and permits analysts to publish research reports about an emerging growth company that is going public even if the analyst's firm is one of the underwriters in the issuer's IPO.

These emerging growth company and "IPO on ramp" provisions can be taken advantage of not only by any issuers who go public in the future, but also by any issuer that has consummated an IPO since December 9, 2011. The "IPO on ramp" period ends upon the earliest of:

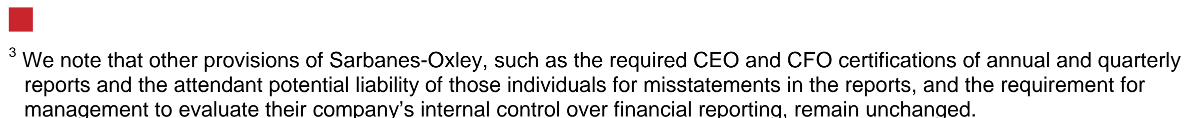
- the last day of the fiscal year in which the issuer achieves annual gross revenues of at least $1 billion;
- the last day of the fiscal year following the fifth anniversary of the issuer's IPO;
- the issuance of more than $1 billion in non-convertible debt during the previous three years; or
- the issuer's becoming a "large accelerated filer" (which generally is an issuer with at least $700 million in public float).

While the JOBS Act by no means overhauls the IPO process for emerging growth companies, it may help minimize the "time to market" and fill in a gap for companies wishing to undertake an IPO that now qualify as emerging growth companies but did not previously qualify as smaller reporting companies, and it reduces audit-related costs and lessens certain ongoing reporting requirements.

Crowdfunding

Under the JOBS Act's new exemption from registration for investments from crowdfunding, companies can raise up to $1 million from an unlimited number of purchasers so long as the offering is made through a qualified broker-dealer or "funding portal" (a new concept created by the JOBS Act) and individual investments are limited to:

- the greater of $2,000 or 5% of the investor's annual income, if the investor's annual income or net worth is less than $100,000; or



[3] We note that other provisions of Sarbanes-Oxley, such as the required CEO and CFO certifications of annual and quarterly reports and the attendant potential liability of those individuals for misstatements in the reports, and the requirement for management to evaluate their company's internal control over financial reporting, remain unchanged.

- 10% of the investor's annual income or net worth (but subject to a $100,000 investment cap), if the investor's annual income or net worth is at least $100,000.

The offering must provide a description of the stated purpose and intended use of the offering proceeds, as well as warnings of the risks related to the investment, and the issuer must take "measures to reduce the risk of fraud" with respect to the transaction. The SEC and investors must be provided with information about the issuer's officers, directors and 20% shareholders, and investors must answer questions demonstrating an ability to understand the risks involved.

If an issuer is targeting total offering amounts of less than $100,000 in a 12-month period, it must provide its most recent income tax return and certified (though not audited) financial statements. For offerings between $100,000 and $500,000, the issuer would need to provide financial statements reviewed by a public accountant. For offerings greater than $500,000, audited financial statements would be required. In addition, issuers would need to factor in fees charged by any intermediary and deal with the challenges presented by having a large, diverse and relatively unsophisticated shareholder base.

Crowdfunding securities would be "covered securities" for state securities law purposes, with the result that state "blue sky" regulation of crowdfunding offerings would be preempted by the federal securities laws. Though removing this layer of regulation may be good news for issuers, state securities regulators have been particularly upset given the potential for fraud in crowdfunding offerings.

While crowdfunding has attracted significant favorable press, use of the crowdfunding provisions is likely to present challenges for a variety of reasons. It seems unlikely that many legitimate issuers would find it attractive to raise $1 million in small investment amounts from a large number of investors, and then to bear the costs of managing such a large shareholder base on an ongoing basis, as well as being subject to SEC oversight and new private rights of action. This is especially true when compared with an issuer's ability to engage instead in a Regulation D offering to accredited investors, which permits general advertising without SEC review of substantive disclosure or a private right of action for negligent misrepresentation. Unfortunately, it is already being predicted that many fraudulent offerings will be conducted under the pretext that they comply with the crowdfunding exemption.

Regulation A+

The JOBS Act provides a new exemption from the registration requirements of the Securities Act modeled on Regulation A, which is being referred to as "Regulation A+". This new exemption increases the permitted size of Regulation A offerings to $50 million of unrestricted securities within a 12-month period to investors, who need not be accredited, subject to the annual filing of audited financial statements and other conditions to be prescribed by the SEC, including periodic reporting requirements. Regulation A offerings, currently limited to sales of up to $5 million of securities in any 12-month period, are subject to fewer disclosure requirements than registered offerings.

Regulation A+ has the advantage, compared with Regulation D, that offerings of unrestricted securities can be made to a large number of non-accredited investors. However, we believe that these advantages are outweighed by several significant drawbacks that, by contrast, are absent from Regulation D:

- SEC review is required;

- Regulation A+ securities would not be covered securities for blue sky purposes, unless the securities are offered and sold on a national securities exchange or sold to "qualified purchasers," a term that must be defined by the SEC; and
- investors will have private causes of action under Section 12(a)(2) of the Securities Act (for negligent misrepresentation).

The existing Regulation A compares very unfavorably with Regulation D and has been rarely used, primarily because of the SEC review process and the fact that securities sold in Regulation A offerings are not covered securities, resulting in significant issuer time and expense devoted to compliance with federal and state securities law regimes. These issues were not addressed by Regulation A+, and we believe that it is unlikely that Regulation A+ will be used any more frequently than the existing Regulation A.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

Louis A. Bevilacqua (bio)
Washington, DC
+1.202.663.8158
louis.bevilacqua@pillsburylaw.com

Joseph R. Tiano, Jr. (bio)
Washington, DC
+1.202.663.8233
joseph.tiano@pillsburylaw.com

David S. Baxter (bio)
New York
+1.212.858.1222
david.baxter@pillsburylaw.com

Ali Panjwani (bio)
New York
+1.212.858.1212
ali.panjwani@pillsburylaw.com

K. Brian Joe (bio)
New York
+1.212.858.1681
k.brian.joe@pillsburylaw.com

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