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JOBS Act Will Ease Rules for IPOs and Private Placements and Reduce Compliance Burdens Post IPO

Will apply to companies with less than $1 billion in gross revenues. Separately, will permit enhanced publicity for Rule 144A and other private offerings, raise maximum number of shareholders for private companies, and facilitate crowdfunding and offerings of $50 million or less.

On March 27, 2012, the US House of Representatives approved the Jumpstart Our Business Startups Act, also known as the JOBS Act, in the form previously approved by the Senate.[1] The Administration has indicated that the President will sign the Act into law during the week beginning April 2, 2012. The Act has broad implications for many companies seeking to raise capital, as it reduces the regulatory burdens of capital raising and ongoing SEC reporting.

Process for IPOs and Other Offerings by Emerging Growth Companies. The Act defines emerging growth companies, or EGCs, as companies that have annual gross revenues of less than $1 billion (including both US and non-US issuers). The Act significantly changes the process for IPOs and, in certain respects, other offerings by EGCs, as described in more detail in Table 1 below. The changes include:

- allowing EGCs and their authorized representatives to test the waters with qualified institutional buyers (QIBs) and institutional accredited investors (IAIs) to gauge their interest prior to (and after) filing a registration statement for any securities offering;
- permitting broker-dealers to issue research reports on EGCs before, during or after IPOs, even if the broker-dealer is participating in the offering;
- allowing research analysts to communicate with investors and management in connection with the IPO of an EGC even if investment bankers are present; and
- permitting EGCs to submit draft IPO registration statements to the SEC for confidential review prior to filing them publicly.

[1] The final text of the Act, as approved by the House on March 27, 2012, and the Senate on March 22, 2012, is available at: http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

Reporting and Other Requirements for EGCs. The Act reduces some public company reporting and other requirements for EGCs for a defined transition period of up to five years post IPO. These provisions exempt EGCs from, among other things, providing more than two years of audited financial statements for their IPOs, complying with the Sarbanes-Oxley Section 404 requirement to have an auditor attestation report on their internal control over financial reporting, conducting "say-on-pay" votes, making certain executive compensation disclosure, and adopting new GAAP pronouncements.

Rule 144A Offerings and Private Placements. The Act directs the SEC to revise its rules within 90 days after enactment to permit general solicitation and advertising for offerings to QIBs and accredited investors made under Rule 144A and Rule 506 of Regulation D, respectively.

Maximum Number of Shareholders for Private Companies. The Act increases the threshold for number of shareholders at which a company must register as an SEC reporting company to either 2,000 shareholders of record or 500 shareholders of record who are not accredited investors.

Crowdfunding. The Act creates an exemption in the Securities Act for crowdfunding offerings that seek small investments from many investors. The Act limits these offerings to not more than $1 million in any 12-month period and directs the SEC to issue rules within 270 days after enactment to implement the new crowdfunding provisions.

Offerings of $50 Million or Less. The Act directs the SEC to create an exemption for public offerings of securities of $50 million or less over a 12-month period.

Significant Changes in Offering Process for IPOs by EGCs

Under the Act, a company qualifies as an EGC if it has gross annual revenues of less than $1 billion. The vast majority of companies that have recently conducted IPOs would have fit that definition. A company does not qualify as an EGC if it conducted its IPO on or before December 8, 2011. A company remains an EGC until the earliest of:

- the last day of the fiscal year during which it has gross revenues of $1 billion or more,
- the last day of the fiscal year following the fifth anniversary of its IPO,
- the date on which it has issued more than $1 billion in non-convertible debt during the previous three years, or
- when it becomes a "large accelerated filer," generally meaning that its public float is $700 million or more.

Table 1 on the following page summarizes the changes that the Act makes in the offering process for EGCs.

TABLE 1: CHANGES IN THE OFFERING PROCESS FOR EGCS

CURRENT RULE	CHANGE FOR EGCS	COMMENTS
Communications Prior to and During a Securities Offering		
Oral offers of securities prior to the filing of a registration statement are prohibited (other than for WKSIs). Written offers of securities are limited to preliminary prospectuses (with a price range if for an IPO) and free writing prospectuses (which must be accompanied or preceded by the preliminary prospectus having the price range if in connection with an IPO).	Permitted to communicate, both orally and in writing, with QIBs and IAIs before and after the filing of the registration statement for any securities offering, whether or not an IPO, in order to gauge their interest in the potential offering. Expressly includes communications by EGCs and persons authorized to act on behalf of EGCs, such as underwriters.	Publicity restrictions continue to apply. Oral and written communications to QIBs and IAIs remain subject to potential liability under Section 12 of the Securities Act for any material misstatement or omission.
Confidential Submission of IPO Registration Statements		
The SEC does not permit issuers to submit IPO registration statements confidentially other than non-US issuers in certain limited circumstances.	Permitted to submit any IPO registration statement and subsequent amendments confidentially, which reverses much of the SEC staff action in December 2011 limiting the use of confidential submission by non-US companies. IPO registration statement and amendments required to be publicly filed with the SEC no later than 21 days before a road show.	If an EGC submits its IPO registration statement to the SEC confidentially, management of the EGC may be limited in its ability to communicate with QIBs and IAIs to gauge their interest in the potential offering for 21 days after the public filing of the registration statement, as the definition of "road show" used by the Act may encompass these communications.
Analyst Research Reports		
Analyst research reports could constitute illegal offers or prospectuses subject to liability under Section 12 of the Securities Act for material misstatements or omissions. Analysts are prohibited from publishing equity research reports during the following quiet periods: (1) 40 days after an IPO, (2) 10 days after a follow-on offering, and (3) 15 days before or after the expiry, waiver or termination of a lock-up agreement.	Publication of research by broker-dealers before, during or after offerings of an EGC's common equity (including an IPO) is not considered an offer or a prospectus, even if the broker-dealer is participating or will participate in the offering. As a result, research reports are no longer subject to liability under Section 12 of the Securities Act for material misstatements or omissions. Neither the SEC nor FINRA may adopt or maintain quiet periods for equity research reports for EGCs in connection with their IPOs and IPO lock-up agreements.	Research reports would still be subject to other potential securities law liability.
Research Analysts' Communications and Meetings		
Research analysts are subject to FINRA rules prohibiting participation in pitch meetings, roadshows or other meetings in which investment banking business is solicited. For broker-dealers subject to the Global Research Settlement, the Global Research Settlement also restricts research analysts' participation in such meetings.	Prohibits the SEC and FINRA from adopting or maintaining rules or regulations in connection with an IPO of an EGC that restrict: • who at a broker-dealer may arrange for communication between a securities analyst and a potential investor, or • participation of a securities analyst in meetings with management at which non-analyst employees of broker-dealers are present.	The Act effectively invalidates already existing SEC and FINRA restrictions on these activities. It is unclear how Global Research Settlement restrictions, which are court ordered, and associated interpretations will be affected.

Reporting and Other Requirements Reduced for EGCs

The Act allows EGCs to present only two years of audited financial statements in an IPO registration statement, rather than the previous three years. In any other registration statement, an EGC need not present selected financial data for any period prior to the earliest audited period presented in its IPO registration statement, rather than the previous five years. Additionally, an EGC is permitted to delay application of any new or revised financial accounting standard applicable to public companies until the standard becomes mandatory for private companies. An EGC has a one-time right to opt into full compliance with public company standards instead.

Although EGCs must continue to comply with the Sarbanes-Oxley requirement to establish and maintain internal control over financial reporting, the Act exempts EGCs from the requirement to obtain an annual attestation report on their internal control over financial reporting from a registered public accounting firm. The existing requirement for CEOs and CFOs to certify public companies' financial statements is not affected.

Pursuant to the Act, EGCs are exempt from compliance with various requirements relating to executive compensation, many of which were implemented pursuant to the Dodd-Frank Act. These include the requirements:

- to hold a "say-on-pay" advisory stockholder vote on compensation of named executive officers (including the corresponding "say-on-pay frequency" vote);
- to make "pay versus performance" disclosure comparing the compensation actually paid to the named executive officers and the issuer's financial performance;
- to provide "internal pay equity disclosure" showing the ratio between the median compensation of the issuer's employees and its CEO; and
- in connection with a merger or acquisition, (i) to provide disclosure on "golden parachute" payments payable to named executive officers and (ii) to hold a non-binding stockholder vote on such payments.

EGCs are also permitted to comply with the reduced compensation disclosure requirements that apply to small businesses with a public float of less than $75 million, which reduce the number of named executive officers from five to three (the CEO and two other most highly compensated executive officers); limit summary compensation table disclosures to two years; eliminate the compensation discussion and analysis, grants of plan based awards table, option exercises and stock vested table, non qualified deferred compensation table and pension benefits table; and eliminate the disclosure of the relationship between compensation and risk, if required.

Liberalization of Publicity for Rule 144A Offerings and Regulation D Private Placements under Rule 506

In a significant change to existing securities law and practice, the Act directs the SEC, within 90 days after enactment, to revise Rule 144A to permit offers to be made to persons other than QIBs, including through general solicitation and advertising, provided that the securities are only resold to persons the seller reasonably believes are QIBs. The Act also requires the SEC, within 90 days after enactment, to revise its rules to permit general solicitation and advertising for offerings made under Rule 506 of Regulation D, provided that all the purchasers of the securities are accredited investors. This change does not increase the 35 non-accredited investors limit currently permitted under Rule 506. In addition, under certain conditions, entities that act as intermediaries for private placements under Rule 506 of Regulation D will not be required to register as broker-dealers.

While some of the changes mandated by the Act are effective when it is signed into law, general solicitation and advertising in connection with Rule 144A offerings and Rule 506 private placements will not be permitted until the SEC revises the applicable rules. Issuers and sellers of securities should establish compliance procedures, including verification procedures to be provided by the SEC in its rules, to avoid sales to ineligible investors. Importantly, the Act has not altered the scope of the anti-fraud liability provisions of the Securities Act and the Exchange Act applicable to disclosures provided to investors.

Higher Maximum Number of Shareholders for Private Companies and Banks and Bank Holding Companies

The Act increases the threshold for the number of shareholders at which a private company is required to register its equity securities with the SEC under the Exchange Act from 500 or more shareholders of record to either 2,000 shareholders of record or 500 shareholders of record who are not accredited investors. The corresponding threshold for banks and bank holding companies is also increased to 2,000 shareholders of record.

Equity securities held by persons who received them through an employee compensation plan in transactions not subject to registration under the Securities Act do not count towards the above thresholds. The Act also directs the SEC to issue a rule within 270 days after enactment exempting crowdfunding investors from the threshold calculation.

Crowdfunding

The Act creates an exemption for a new type of small securities offering known as crowdfunding, which involves seeking small investments from many investors. The Act also requires the SEC to issue rules within 270 days after enactment implementing the new crowdfunding provisions of the Securities Act. Under new Section 4(6) of the Securities Act, an issuer (including all entities controlled by or under common control with the issuer) may raise up to $1 million in any 12-month period using this crowdfunding exemption. During any 12-month period, investors in crowdfunding offerings by a single issuer may only invest (i) the greater of $2,000 or 5% of their annual income or net worth, if either their annual income or net worth is less than $100,000 and (ii) 10% of their annual income or net worth, to a maximum of $100,000, if either their annual income or net worth is equal to or more than $100,000. Securities sold in a crowdfunding offering will be subject to resale transfer restrictions.

The Act requires that crowdfunding offerings be conducted through a broker or "funding portal" that meets certain conditions. Among other conditions, the broker or funding portal must:

- register with the SEC and any applicable self-regulatory organization;[2]
- provide specified investor education materials to investors;
- question investors regarding their understanding of risks involved in crowdfunding;
- conduct background checks of the issuer's executive officers, directors and major shareholders;

[2] Under new Section 3(h) of the Exchange Act, this provision will widen the unusual, but not unprecedented, category of entities that are not registered with the SEC as broker-dealers but are members of FINRA and subject to FINRA rules.

- not compensate promoters, finders or lead generators for providing the personal identifying information of any potential investor; and
- not allow any of its directors, officers or partners to have a financial interest in an issuer using its services.

The Act requires an issuer to meet certain conditions for crowdfunding. Among them are:

- providing to the SEC, investors, and the broker or funding portal certain disclosure about the issuer, including, for an issuer raising $100,000 or less in the preceding 12 months (including the current offering), income tax returns and financial statements certified by its CEO, for an issuer raising more than $100,000 but not more than $500,000, financial statements reviewed by a public accountant, and for an issuer raising more than $500,000, audited financial statements;
- not advertising the terms of the crowdfunding offering, other than directing investors to the broker or funding portal they are using;
- ensuring that promoters of the offering disclose in their promotional communications, in accordance with rules prescribed by the SEC, the receipt of any compensation (past or prospective) for that promotion;
- filing with the SEC and providing to investors annual reports of results of operations and financial statements, as the SEC directs; and
- not being subject to disqualification as a "bad actor."

Offerings of $50 Million or Less

The Act directs the SEC to create a new exemption (or modify an existing exemption, such as that provided by Regulation A) for public offerings of equity securities, debt securities and debt securities convertible or exchangeable into equity securities that, in the aggregate, do not exceed $50 million in any 12-month period. Under this exemption, securities may be publicly offered, and interest in an offering may be solicited before the filing of any offering statement, subject to any terms and conditions set by the SEC. These offerings will be subject to liability for material misstatements or omissions under Section 12(a)(2) of the Securities Act. Securities sold under this new exemption will not be restricted securities and thus could be freely resold by most security holders. They will generally not be subject to state "blue sky" regulation.

In addition, issuers offering securities under this new exemption must not be subject to disqualification as a "bad actor" and will be required to file audited financial statements with the SEC annually, make periodic disclosure as the SEC directs and prepare and file with the SEC and distribute to investors an offering statement including, among other items, audited financial statements, a description of the issuer's business and financial condition and its corporate governance principles.

Conclusion

The Act makes substantial changes to the existing federal securities law regime and mandates that the SEC engage in new rulemaking that liberalize the securities laws in an effort to make the US capital markets more attractive by reducing costs and other barriers to access US capital markets. It will be some time before the full extent and implications of changes made by the Act become clear. Shearman & Sterling will provide updates on these new provisions, the SEC's reaction, and how these new provisions affect market practice by issuers and investment banks.

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