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House and Senate Pass Bill Simplifying IPO Process and Private Capital Raising

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On March 27, 2012, the U.S. House of Representatives voted to approve amendments made by the Senate to the *Jumpstart Our Business Startups Act*, or "JOBS Act." The JOBS Act, which was first passed by the U.S. House of Representatives with overwhelming support on March 8, 2012, and later passed by the Senate with certain amendments on March 21, 2012, aims to reduce the costs of going public for private companies and ease capital raising for private companies. Now that the amended version has passed in both the House and the Senate, the JOBS Act is pending approval by President Obama, who has expressed his support for the bill. It is expected that the JOBS Act will very soon become law.

As the JOBS Act made its way through Congress, a number of industry groups and organizations voiced both support and concerns. While the North American Securities Administrators Association expressed opposition to the relaxed regulations in the JOBS Act, both the National Venture Capital Association as well as several hundred entrepreneurs urged legislators to approve the bill. The JOBS Act encompasses reforms in two general areas: (1) making the IPO process less burdensome for smaller companies with the benefit of an "on ramp" regulatory regime characterized by reduced regulation, and (2) easing regulatory restrictions on private capital formation that has been curtailed under the existing regulatory regime that is outmoded and does not reflect current communications technology and recent innovation in social media.

Reforms in the IPO Process

Intrinsically, the regulatory requirements for an IPO were the same regardless of the size of the company, which many believe has contributed to a decrease in the number of IPOs by smaller companies. The JOBS Act creates a new class of public companies called "Emerging Growth Companies," defined as those that had less than $1 billion in annual gross revenues during their most recently completed fiscal year.

For Emerging Growth Companies, provisions in the JOBS Act ease the burdens associated with going public, both in connection with the IPO itself, as well as in the early years as a public company. Emerging Growth Companies will be able to take advantage of the lighter rules until the earliest of:

- the last day of the fiscal year during which the company's annual gross revenues exceeded $1 billion;
- the last day of the fiscal year following the fifth anniversary of its IPO;
- the date on which the company has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or

- the date on which the company is deemed to be a "large accelerated filer" (that is, a company with an unaffiliated public equity float of at least $700 million which has been reporting for at least one year).

IPO On-Ramp

Under provisions in the JOBS Act, an Emerging Growth Company can take advantage of reforms aimed at making the IPO process more attractive to small companies – a so-called "IPO on-ramp." The IPO on-ramp will allow Emerging Growth Companies to do the following:

- Confidentially submit a draft registration statement to the SEC for confidential nonpublic review prior to filing, provided that the initial submission and all amendments thereto are publicly filed at least 21 days prior to conducting a road show. This option is intended to facilitate increased dialogue between Emerging Growth Companies and the SEC, and will allow those companies to consider an IPO without first publicly releasing sensitive information.

- Communicate with qualified institutional buyers and accredited investors to determine whether such investors would have an interest in the contemplated offering before or after the filing of a registration statement. This option will allow Emerging Growth Companies to test the waters for a contemplated offering without being subject to current quiet period gun jumping restrictions on pre-offering communications.

- Limit the information provided in the IPO registration statement, including two years (instead of three) of audited financial statements in its IPO registration statement, selected financial data only beginning with the earliest period presented in the IPO registration statement (rather than for the previous five years), and reduced-in-scale executive compensation disclosure. These accommodations will reduce the audit costs associated with an IPO.

In addition, the JOBS Act eases restrictions on research published by investment banks around the time of a company's public offering. Such accommodations address a perceived lack of research coverage for emerging companies by permitting broker dealers – including participating underwriters – to publish reports about an Emerging Growth Company, even in the period immediately following its IPO, which current rules limit. The JOBS Act also removes certain restrictions regarding communications between securities analysts and potential investors, which will allow this important source of information to be made available to investors as part of the offering process.

Early Post-IPO Years

Beyond simplifying the IPO process for Emerging Growth Companies, the JOBS Act eases regulatory restrictions for these companies in the early years post-IPO. For as long as a company maintains its status as an Emerging Growth Company, it will be permitted to adhere to the following, less rigorous requirements:

- For reports filed with the SEC and any post-IPO registration statements, Emerging Growth Companies will be able to include reduced in scale executive compensation disclosure (applicable to smaller reporting companies) and present selected financial data only beginning with the earliest period presented in the IPO registration statement.

- Emerging Growth Companies will be exempt from:

  – the auditor attestation requirements in 404(b) regarding internal control over financial reporting;

  – holding say-on-pay votes and disclosing certain executive compensation information (such as pay versus performance ratios);

- complying with any new or revised U.S. GAAP accounting standards, until such standards are also applicable to private companies; and
- complying with any new PCAOB rules requiring mandatory audit firm rotation or a supplement to the auditor's report.

Reforms in Private Capital Raising

In addition to reforms in the IPO process, the JOBS Act includes measures that aim to facilitate capital formation through private offerings. The legislation will implement regulatory reform that has been recommended to the SEC for almost a decade.

Elimination of Solicitation Prohibitions

General solicitation and advertising are currently prohibited for private placements of securities, including Rule 144A offerings. The JOBS Act requires the SEC to amend Regulation D and Rule 144A to allow general solicitation and advertising, even to non-accredited investors, so long as the issuing company takes reasonable steps to ensure that any actual sales of securities are made to, as applicable, accredited investors or qualified institutional buyers.

While companies may face added steps to ascertain the identity and qualifications of any purchasers, allowing general solicitation will open the door for companies to solicit a much broader base of potential investors through modern day online and social media communication portals.

For a more in-depth discussion of the general solicitation reforms, see our Stay Current client alert, *Demystifying the Recently Enacted Crowdfunding and Private Offering Reforms: Opportunities for Issuers and Investors*.

Expansion of Regulation A

Regulation A currently offers an exemption from certain registration requirements for public offerings of securities of $5 million or less that are sold over a 12-month period. Given the low dollar threshold, Regulation A is rarely used. Regulation A requires the filing with the SEC of an offering statement containing an offering circular, the form and content of which is less burdensome to prepare when compared to the content of an IPO prospectuses for a registered public offerings. Under the JOBS Act, Regulation A will be amended to increase the cap on offering size to $50 million in a 12-month period, making it a viable capital raising platform again.

In addition to the increased cap, the JOBS Act mandates a study on the impact of Blue Sky securities laws on offerings made under Regulation A. An earlier version of the legislation would have preempted the application of Blue Sky laws to Regulation A offerings intermediated by SEC registered broker-dealers, but this element was removed under pressure from state Blue Sky authorities. Depending on the outcome of the study, additional reforms may be made, such as preempting the application of Blue Sky laws to Regulation A offerings.

Crowdfunding

Crowdfunding is a relatively new method of fundraising in which groups of small investors pool their resources to fund companies seeking capital. In practice, crowdfunding tends to apply mostly to early stage companies. The JOBS Act will amend Section 4 of the Securities Act to provide a new exemption from registration requirements targeted at facilitating crowdfunding. The amendments to the original bill passed by the House are found in the crowdfunding provisions, and aim to provide additional investor protection by placing further limitations on this exemption.

The exemption will apply to private companies selling up to $1 million of securities over a 12-month period. The investment by any single investor in such an offering may not exceed, as applicable (1) the greater of $2,000 or 5% of the annual income or net worth of such investor, if either the

annual income or the net worth of the investor is less than $100,000, or (2) 10% of the annual income or net worth of such investor, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is $100,000 or more. Securities issued through the crowdfunding exemption will be treated as "covered securities" and therefore be exempt from registration under state Blue Sky laws, and investors purchasing such securities will be exempt, conditionally or unconditionally (as determined by the SEC), from the shareholder threshold calculations in Section 12(g) of the Securities Exchange Act.

The legislation also imposes additional requirements on companies and their intermediaries taking advantage of the exemption:

- The company must file with the SEC, and provide to investors and intermediaries, certain information aimed at informing a potentially unsophisticated shareholder base, including:
  - a description of its business, anticipated business, and financial condition;
  - financial statements that will, depending on the aggregate size of all offerings by the company under this exemption in the prior 12-month period, need to be either (1) certified by an officer of the company (for offerings totaling $100,000 or less), (2) reviewed by an independent accounting professional (for offerings totaling between $100,000 and $500,000), or (3) audited (for offerings totaling more than $500,000);
  - a description of the offering, including target amount to be raised, certain deadlines, use of proceeds, and risk factors; and
  - not less than annually (subject to exceptions and terminations as determined by the SEC) reports of operations and certain financial statements.
- The company may not advertise terms of the offering, other than through notices that direct investors to the intermediary.
- The transaction must be conducted through either a broker or a funding portal. A funding portal will be an intermediary through which crowdfunding capital is raised but which is exempt from registering as a broker-dealer, so long as it registers as a "funding portal" and satisfies certain recordkeeping and operational requirements. Whether brokers or funding portals, intermediaries will be required take certain measures to reduce the risk of fraud and provide investors ongoing access to company information.

For a more in-depth discussion of the crowdfunding reforms, see our Stay Current client alert, *Demystifying the Recently Enacted Crowdfunding and Private Offering Reforms: Opportunities for Issuers and Investors*.

Increase in Public Company Reporting Thresholds

Currently, Section 12(g) of the Securities Exchange Act mandates that private companies with more than 500 shareholders of record and more than $10 million in assets comply with public company reporting requirements. The 500 shareholder threshold has been a burden on many private companies, as they have issued shares to an increasing number of employees and simultaneously seen an increase in the liquidity of private company shares in developing secondary markets. The JOBS Act not only raises the shareholder threshold triggering reporting requirements to 2,000 (or 500, for shareholders that are not accredited investors as defined in SEC regulations), but it also excludes from the threshold calculation any employees holding only shares issued under equity compensation plans. In addition, the JOBS Act requires the SEC to exempt from the Section 12(g) threshold calculations, conditionally or unconditionally, securities acquired in crowdfunding exempt offerings.

Similarly, the JOBS Act permits banks and bank holding companies to reach $10 million in assets and 2,000 shareholders before triggering public company reporting requirements (as opposed to the current threshold of $1 million in assets and 500 shareholders).

Final Thoughts on Potential Impact of the JOBS Act

After receiving overwhelming bipartisan support in its passage through both chambers of Congress, at this stage it is expected that the JOBS Act will very soon become law. The only remaining step is the President's signature, which he has indicated he will give. Once that happens, the measures in the JOBS Act are poised to pave the way for an increased number of smaller company IPOs and have a significant effect on the way private offerings are structured.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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