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The March Toward Reform For Emerging Growth Cos.

Law360, New York (March 21, 2012, 12:52 PM ET) -- Building on months of momentum in Congress, on March 8, 2012, the U.S. House of Representatives passed the Jumpstart Our Business Startups (JOBS) Act by a bipartisan vote of 390-23. A similar bill, S. 1933, has been introduced in the Senate and may be voted on this month. The JOBS Act is intended to address the sharp decline in U.S. public offerings during the last decade and to facilitate capital raising by smaller companies.

The provisions of the JOBS Act will, if enacted, represent a watershed change to the laws and regulations governing capital raising for private companies and would create a limited, temporary and scaled regulatory compliance pathway, referred to as an "IPO on-ramp," for companies going public and newly public companies. The IPO on-ramp is designed to reduce the costs and uncertainties of accessing public capital.

Background

Inspired from the work of the U.S. Department of the Treasury's Access to Capital Conference in March 2011 and the recommendation of a group called the IPO Task Force, congressional action has been gaining momentum, culminating in the passage by the House of the JOBS Act.

According to the National Venture Capital Association, from 1990 to 1996, 1,272 U.S. venture-backed companies went public on U.S. exchanges; yet from 2004 to 2010, there were just 324 of those offerings. Participants in the U.S. capital markets have cited a number of reasons for this decline, including electronic trading, eroded profits from trading in smaller cap companies, the ever-increasing compliance burden on public companies and post Sarbanes-Oxley restrictions on research analysts. The JOBS Act includes a number of regulatory and market-based reforms designed to stem the decline and modernizes a regulatory scheme that largely predates the Internet.

Overview

The JOBS Act contains the following reforms to U.S. securities laws and regulations which, if enacted into law, would:

- create a new category of issuer — emerging growth companies — with limited, scaled relief from various financial reporting, disclosure and governance rules for up to five years after an IPO
- remove the prohibition on general solicitation in Regulation D for offerings sold only to accredited investors
- permit nonbroker-dealers to operate online or offline exchanges for the trading of privately-placed securities
- permit "crowdfunding" offerings that raise small amounts of capital from a large number of investors
- require the SEC to amend Regulation A (or adopt a new similar exemption) to increase the offering limit to $50 million and to make preemption of state blue sky qualification requirements available, making Regulation A a viable alternative to Regulation D, particularly where a liquid secondary market is desired
- increase the threshold number of holders for mandatory registration under the Securities Exchange Act of 1934 from 500 to 2,000, and exclude employees who received securities under an employee compensation plan and "crowdfunding" purchasers from the count

What Are Emerging Growth Companies, and What Relief Will They Get?

An emerging growth company is a company that has had its first registered sale of securities within its five prior fiscal years and has total annual gross revenues of less than $1 billion and less than $700 million in publicly traded shares. The JOBS Act provides the following limited, scaled, temporary relief from disclosure, compliance and governance obligations:

- Compliance with the auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act would not be required during the period that a company remained an emerging growth company. As is the case currently for smaller reporting companies and non-accelerated filers, emerging growth companies would be required to maintain adequate internal control over financial reporting and report the assessment of their principal executive officer and principal financial officer as to the effectiveness of such internal control.
- Compliance with new accounting standards would not be required until such standards apply to companies that are not subject to Exchange Act reporting.
- Audited financial statements would be required for only the two prior fiscal years rather than the three prior years required for companies other than smaller reporting companies.
- Say-on-pay and say-on-golden-parachute votes would not be required during the period the company qualifies as an emerging growth company. Smaller reporting companies are currently exempt from these votes until 2013.
- Rules prohibiting brokers-dealers participating in the offering from publishing research reports on companies until the lapse of 40 days after an IPO would be repealed. Such publications would not be deemed an "offer" of securities and therefore could not represent "gun-jumping."
- SEC and stock exchange rules limiting communications by analysts with companies and potential IPO investors would be repealed.
- "Testing the waters" communications between companies and qualified institutional buyers (QIBs) would be permitted at any time during the IPO process.
- Registration statements could be submitted confidentially to the SEC and need not be publicly available until 21 days prior to the first road show.

What Is the Elimination of the Prohibition on General Solicitation?

Currently, a company wishing to raise capital through the exemption from registration provided in Rule 506 of Regulation D must not offer its securities by any form of general solicitation or advertising. The prohibition on general solicitation requires investors to be recruited based on pre-existing relationships with the company or an agent of the company that create a reasonable basis to believe that a person would be interested in an investment of the type offered. This rule represents the fundamental divide between registered public offerings, such as IPOs, and exempt offerings, commonly known as private placements.

The JOBS Act would remove the prohibition on general solicitation in Rule 506 private placements provided that all the investors are accredited. The JOBS Act directs the SEC to adopt regulations to require the issuer to take reasonable steps to verify that the purchasers in Rule 506 private placement are accredited. The reform applies only to offerings under Rule 506 and does not directly affect offerings under other exemptions afforded by Regulation D or Section 4(2) of the Securities Act of 1933.

Rule 506 offerings are exempt from state blue sky qualification requirements under the National Securities Markets Improvement Act of 1996 (NSMIA), so the general solicitation that would be permitted by the JOBS Act could not be restricted by states.

In addition, the JOBS Act directs the SEC to amend Rule 144A to permit general solicitations of securities sold under Rule 144A that reach investors who are not QIBs, provided that only QIBs (or institutions reasonably believed to be QIBs) purchase such securities.

What Types of Exchanges Will Nonbroker-Dealers Be Permitted to Operate for the Resale of Privately Purchased Securities?

The JOBS Act would create an exception to broker-dealer registration rules for operating a platform or mechanism to offer, sell and purchase securities originally sold under Rule 506 and for providing certain ancillary services associated with such securities. The permitted ancillary services are due diligence services and providing standardized transaction documents. The exception would apply to online and other types of exchanges.

This exception would apply only if the operator and associated persons receive no compensation in connection with the purchase or sale of securities, do not take possession of customer funds and have not been subject to a “bad boy” disqualification from a self-regulatory organization such as FINRA.

What Is Crowdfunding, and What Activities Will the JOBS Act Permit?

Crowdfunding is a form of capital raising where groups of people pool money and other resources to achieve a goal, including to fund a small business. As a result of the prohibition on general solicitation and the requirement for companies to register under the Exchange Act if they have over 500 holders of a class of equity securities and over $10 million of assets, crowdfunding in the U.S. through websites and social networks has generally been limited to activities where the investor does not receive securities in exchange for its financial contribution.

The JOBS Act would create a new statutory exemption (Section 4(6) of the Securities Act) for transactions where:

- less than $1,000,000 of securities are sold during the prior 12 months, or $2,000,000 if the issuer provides investors with audited financial statements
- the aggregate amount sold to any investor within the prior 12 months does not exceed the lesser of $10,000 or 10 percent of such investor's annual income
- the issuer or an intermediary warns investors of the speculative nature of investments in startups, including illiquidity
- no resales are permitted for one year except to the issuer or an accredited investor, and the issuer or an intermediary warns investors of this restriction
- the issuer or an intermediary takes reasonable measures to reduce the risk of fraud
- the issuer or an intermediary provides the SEC with certain identifying information, a notice of the offering, including the intended use of proceeds (due no later than the day the offering commences), and a further notice of the completion of the offering, including the aggregate offering amount and the number of investors
- the issuer or an intermediary provides the SEC continuous investor-level access to its website
- the issuer or an intermediary requires each potential investor to answer questions demonstrating an understanding of the level of risk
- the issuer or an intermediary states a target offering amount and a deadline to reach the target and discloses the same in the notice provided to the SEC
- the issuer or an intermediary makes available on its website a method of communication that permits the issuer and investors to communicate with one another
- the issuer or an intermediary does not offer investment advice
- all investments are held with a custodian until 60 percent of the disclosed target offering amount is hit

Intermediaries, if used in the offering, would also be required to perform background checks on the issuer's principals. Intermediaries would not need to be registered broker-dealers.

It appears that securities sold under the crowdfunding exemption would be "restricted securities" and therefore subject to Rule 144 restrictions for public resales. It appears that the one-year restriction on resale described above would apply to private as well as public resales.

Investors who purchase securities in transactions under the crowdfunding exemption would not count against the holders of record test that triggers reporting obligations for companies under Section 12(g) of the Exchange Act. Moreover, offerings under the crowdfunding exemption would preempt state blue-sky qualification laws (though the SEC must make information available to the states to facilitate state enforcement of anti-fraud laws).

Within 180 days after the enactment of the JOBS Act, the SEC would be required to adopt rules for the crowdfunding exemption, including rules disqualifying "bad boys" from using the exemption.

What Is the Change to Regulation A, and What Does It Mean?

Regulation A currently provides an exemption from registration for offerings of up to $5 million per year by nonreporting companies. Regulation A requires the submission of a simplified offering document to the SEC, and the SEC may comment upon them. Regulation A permits “testing the waters” communications. Securities sold under Regulation A are not “restricted securities,” so the investor can immediately sell such securities publicly, at least theoretically. Issuers who sell securities under Regulation A do not automatically become subject to reporting under the Exchange Act. Regulation A offerings are subject to state blue-sky qualification laws. Regulation A is rarely used today because of the low $5 million offering cap and the associated regulatory burdens.

The JOBS Act would require the SEC, within one year of enactment of the JOBS Act, to amend Regulation A (or adopt a new exemption) to increase the offering cap to $50,000,000 of securities sold in the prior 12 months in reliance on the exemption. The exemption would continue to permit testing the waters communications, permit offering the securities publicly, and provide that securities sold in the offering are not restricted securities.

The exemption would require issuers availing themselves of the modified exemption to file audited financial statements with the SEC annually and allow the SEC to impose additional conditions, including periodic reporting requirements. The exemption would be available for equity securities, debt securities, convertible debt securities and guarantees.

Securities sold under the modified exemption would be added to the list of covered securities under NSMIA, but only if they are offered and sold on a national securities exchange or offered and sold only to “qualified persons” as the term is defined by the SEC. NSMIA was adopted in 1996 and preempted state blue-sky qualification laws for securities sold to qualified persons. The SEC proposed a definition for “qualified persons” in 2001, but never adopted a definition.

If the SEC does not adopt a definition in connection with the amendments to Regulation A required by the JOBS Act, issuers would have to choose between blue sky compliance and becoming listed on a stock exchange, assuming they qualify for listing. Becoming listed on a stock exchange would in turn require issuers to report under the Exchange Act, which may eliminate many of the advantages of Regulation A over a registered public offering.

Depending on the regulations the SEC adopts, Regulation A may become a viable means for a company to conduct a “mini-public offering” and have a public trading market in its securities. The continuing market for reverse mergers into public shell companies, sometimes referred to as alternative public offerings, demonstrates a demand for small companies to establish public markets in their securities. The ability to raise up to $50 million publicly and the potential not to be subject to Exchange Act reporting could make Regulation A a superior alternative public offering method.

What Are the Changes to the Triggers for Exchange Act Registration?

Section 12(g) of the Exchange Act and its related rules require a company with more than $10 million in assets and more than 500 holders of record of any class of its equity securities to register under the Exchange Act and begin complying with disclosure and financial reporting compliance obligations applicable to public companies.

The JOBS Act would increase the holder threshold to 2,000 holders, provided no more than 500 are unaccredited investors. The JOBS Act would also exclude from the “held of record” test securities held by persons who received them pursuant to employee compensation plans and securities held by persons who purchased them in transactions under the crowdfunding exemption.

The holder of record threshold for banks and bank holding companies would increase to 2,000, with no limit on the number of unaccredited investors.

Is There Anything Else?

Yes. The JOBS Act orders the SEC to conduct a study examining its decimalization rules adopted in 2001. These rules required securities quotations in pennies rather than fractions of a dollar, and thus were intended to decrease trading transaction costs.

Many blame these rules, among others, for the decline of public offerings. The argument is that decimalization has reduced the bid-ask spreads from market-making to a level that makes trading desks unprofitable for all but the largest investment banks, and that in turn has caused post-IPO stocks to be illiquid and eliminated most regional and "boutique" banks from the IPO market.

The JOBS Act also directs the SEC to conduct a review of Regulation S-K and "determine how such requirements can be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with these requirements for issuers who are emerging growth companies."

What Will Happen Next?

Recent press reports indicate that the Senate is likely to take up the companion S. 1933 this month. President Obama has announced his support for the JOBS Act and, given its overwhelming bipartisan support, passage seems likely in this election year.

What Should Companies Do Now?

The JOBS Act is not currently law, so existing laws, regulations and rules applicable to capital raising and public reporting remain in effect. Issuers with ongoing offerings or offerings about to commence must continue to comply with existing laws, regulations and rules.

The changes that would be implemented by the JOBS Act, if adopted, will fundamentally change the methods companies have used to raise capital for the last 30 years. While there will certainly be significant changes in the markets for growth capital, it is too early to predict how markets, issuers and intermediaries will react to the rule changes.

For example, it is too early to predict what impact general solicitation will have on the success of Rule 506 offerings or whether the new crowdfunding exemption or Regulation A exemption will become viable fundraising alternatives for companies seeking growth capital and/or public markets in their securities.

Companies and entrepreneurs should monitor this situation closely and expand their medium- and long-term thinking around capital raising to accommodate the changes that appear to be imminent.

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