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Jumpstart Our Business Startups Act – Implications for Issuers and Financial Institutions

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On March 27, 2012, the U.S. House of Representatives adopted the Jumpstart Our Business Startups Act (the "JOBS Act") with strong bipartisan support, sending the bill to President Obama to sign. The JOBS Act is intended to stimulate economic growth by improving access to the U.S. capital markets for U.S. and foreign startup and emerging companies. The President is expected to sign the JOBS Act into law this week.

Many business groups, including the U.S. Chamber of Commerce, support the JOBS Act and believe it will facilitate capital raising by small companies, allow emerging growth companies to make a transition to public company status while continuing to grow and create jobs, and reduce some of the regulatory burdens imposed by the Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley"). While certain provisions in the JOBS Act will provide added flexibility to such earlier stage companies, its potential impact on the capital markets remains unclear. Many industry participants are concerned that the JOBS Act may erode investor protections and leave investors susceptible to securities fraud. In addition, because the JOBS Act did not alter the liability regime under U.S. securities laws, it remains unclear how market practices will change or develop for issuers and financial institutions. Such new market practices will depend, in large part, on the rules and guidance provided by the Securities Exchange Commission (the "SEC") and other regulatory agencies such as the Financial Industry Regulatory Authority ("FINRA"), which we will continue to monitor.

Summary of the JOBS Act

Public Capital Market Reforms – the "IPO On-Ramp" for Emerging Growth Companies

Title I of the JOBS Act, referred to as the "IPO On-Ramp," eases the public reporting requirements and should lower the costs of an initial public offering ("IPO") generally for certain issuers. Specifically, it creates a new category of public issuer called an "Emerging Growth Company." Emerging Growth Companies are defined as an issuer that had total annual gross revenues of less than $1 billion (an amount that is to be indexed for inflation every five years). A public issuer will remain an Emerging Growth Company until the earliest of:

(1) the last day of the fiscal year during which it had total annual gross revenues of $1 billion;

(2) the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of its common equity securities;

(3) the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or

(4) the date on which such public issuer is deemed to be a "large accelerated filer" under the Securities Exchange Act of 1934, as amended (the "Exchange Act") (i.e., has a public float greater than $700 million).

As of the earliest of such dates, a public issuer must comply with all of the filing and reporting requirements of the SEC. Additionally, a company may only qualify as an emerging growth company if its first public sale of common equity pursuant to an effective registration statement occurred after December 8, 2011. It is estimated that over 90% of companies that filed for IPOs in 2011 would have qualified as Emerging Growth Companies.

Under Title I of the JOBS Act, Emerging Growth Companies would be exempt from certain regulatory requirements, or have their compliance obligations reduced, as follows:

- Reduction in financial information to be included in SEC filings. An Emerging Growth Company will only have to supply the SEC with two years of audited financial statements in its IPO registration statement, as opposed to the current three-year requirement. In any subsequent registration statement, an Emerging Growth Company will not need to present selected financial information or any management's discussion for any period prior to the earliest audited period presented in connection with its IPO. While these advantages are enticing, Emerging Growth Companies will need to consider whether such reduced disclosure will affect the marketability and value of their securities when compared to companies that provide such information.

- Confidential review of draft registration statements. Emerging Growth Companies will be allowed to submit a draft of its IPO registration statement for confidential review by the SEC prior to making a public filing. The confidential filing and any amendments would be publicly filed with the SEC not later than 21 days before the issuer conducts its road show. We expect that most, if not all, Emerging Growth Companies will take advantage of this opportunity, which is a significant departure from current rules.

- Easier communication with qualified institutional buyers and accredited investors. It would be permissible for an Emerging Growth Company or its authorized representative to communicate orally or in writing with Qualified Institutional Buyers ("QIBS") and institutions that are accredited investors to determine whether such investors would have an interest in a contemplated securities offering (i.e., they can "test the waters"). Such communications could take place before or after the filing of a registration statement. Although there are many potential advantages to these changes, there are some issues that will need to be considered. For example, there is no requirement that materials used in such communications be filed at any time with the SEC, which creates a potential risk that different information could be distributed to different groups of investors. It is also unclear how advantageous this change will be for Emerging Growth Companies that are already public, as they will need to comply with Regulation FD.

- Research reports from underwriting banks and analyst communications. Investment banks will be permitted to publish research reports during the pendency of a public offering, even if they act as underwriters, as such reports will not be deemed to constitute a regulated offer. The research analyst conflict of interest rules and "three-way" communication between research, investment banking and management will not apply to Emerging Growth Companies. Therefore, research analysts will be allowed to make appearances (such as at investor conferences or on TV shows) and participate in meetings with Emerging Growth Companies and their investment bankers. The SEC and FINRA will not be able to impose rules that restrict such activities (i.e., there will not be any post-pricing or booster shot restrictions on research reports or other communications).

While the JOBS Act permits investment banks to distribute research before any offering, including IPOs, it is not yet clear to what extent this new flexibility will be utilized in light of the continued application of securities law liability for misleading research reports and the potential for litigation. There is a risk that some investors would rely on research reports rather than the statutory offering documents. It also is unclear how the JOBS Act might affect the contractual obligations of the financial institutions that are party to the Global Research Settlement. In addition, other FINRA rules that restrict research and the participation of analysts will continue to remain in effect unless they are changed.

- Exemption from auditor attestation of internal controls. Title I of the JOBS Act exempts auditors from the requirement to provide an attestation report on Emerging Growth Companies' internal controls for financial reporting under Section 404(b) of Sarbanes-Oxley, which is generally required between one and two years after a company becomes a public reporting company unless it qualifies as a smaller reporting company. This change is expected to significantly reduce public company compliance costs for Emerging Growth Companies. However, the lack of an auditor attestation report could also negatively impact investor confidence, with a corresponding reduction in the value of a company's securities, when compared to similar companies that provide such reports. Alternatively, some institutional investors may revise their investment guidelines in response to the JOBS Act and choose not to invest in public companies that do not include an auditor attestation of their internal controls. In addition, underwriting financial institutions may need to consider their due diligence procedures for Emerging Growth Companies in light of the absence of such reports.

- Exemption from new accounting standards and rules. Emerging Growth Companies will not be subject to new or revised financial accounting standards until such standards apply to companies that are not reporting companies under the Exchange Act. An Emerging Growth Company may choose to comply with all standards applicable to non-Emerging Growth Companies but cannot choose to comply with only certain standards. Title I of the JOBS Act also provides that any rules of the Public Company Accounting Oversight Board ("PCAOB") requiring mandatory audit firm rotation or supplementary information about an audit and an issuer's financial statements will not apply to an audit of an Emerging Growth Company. Moreover, any additional rules adopted by the PCAOB following the date on which the JOBS Act is enacted will not apply to an Emerging Growth Company unless the SEC determines that such application is necessary for the public interest and has considered the protection of investors and whether the new requirement will promote efficiency, competition and capital formation.

- Relief from executive compensation disclosure and say-on-pay votes. Emerging Growth Companies will be able to comply with the reduced executive compensation disclosure requirements of smaller reporting companies and not need to disclose the ratio of a CEO's compensation to the median compensation of all other employees at the company. Title I of the JOBS Act also exempts Emerging Growth Companies from needing to give its shareholders a non-binding vote on executive compensation until one to three years after it ceases to be an Emerging Growth Company.

Private Capital Market Reforms

Elimination of Ban on General Solicitation and Advertising in Private Offerings

Title II of the JOBS Act will require the SEC to eliminate the prohibition against general solicitation or general advertising when conducting private placements under Rule 144A and Rule 506 of Regulation D. These changes will allow companies to advertise broadly when conducting private placements so long as securities are purchased only by QIBs (generally large institutions with over $100 million of assets under management) or accredited investors (generally individuals with a net worth in excess of $1 million, excluding personal residences), respectively. Consequently, the new legislation will allow advertisements for private offerings and will also allow

private offerings to be conducted concurrently with public offerings. Issuers will still need to make reasonable efforts to ensure that each purchaser is either a QIB or an accredited investor, as applicable. Finally, any person that sold securities in a valid private placement under Rule 506 will not be subject to broker-dealer registration for offering activities on trading platforms if certain conditions are met (e.g., no compensation for the purchase or sale of securities and no possession of customer funds or securities in connection with such purchase or sale).

Exemption for "Crowdfunding" Transactions

Title III of the JOBS Act would permit certain "crowdfunding transactions," which would allow groups of people to pool funds consisting of small individual contributions for an enterprise. Non-reporting issuers will be able to raise up to $1 million within any 12-month period. Individuals with annual income or net worth of less than $100,000 will be able to invest no more than the greater of $2,000 or 5% of their annual income or net worth in any 12-month period, and those with annual income or net worth greater than $100,000 can invest up to 10% of their annual income or net worth annually (with a cap of $100,000 per investor annually).

There will be requirements with respect to a company's financial statements depending upon the amount of funds raised:

- raising amounts up to $100,000 annually requires the certification of the principal financial officer that the financial statements are true and correct;

- raising amounts between $100,000 and $500,000 annually will require review by an independent public accountant; and

- raising amounts above $500,000 annually will require audited financial statements.

Offerings will have to be conducted through a broker or a "funding portal." Issuers may not advertise the terms of the offering other than to direct investors to brokers or funding portals and issuers will be required to file with the SEC and provide to investors and intermediaries a range of information regarding the offering and the issuer (at least 21 days prior to the first sale to any investor and not less than annually thereafter). Securities issued will be "covered securities" and exempt from state Blue-Sky registration and will be subject to transfer restrictions (with limited exceptions) for one year.

Increase in Exemption Limit for Small Offerings

Title IV raises the limit for Regulation A (the small offerings exemption) offerings from $5 million to $50 million in any 12-month period and exempts Regulation A offerings from state securities laws, so long as the securities are (1) offered or sold over a national securities exchange or (2) sold to a "qualified purchaser" (a term that will need to be defined by SEC rulemaking). The revised Regulation A will require issuers to file audited financial statements annually with the SEC and the JOBS Act directs the SEC to develop rules relating to periodic disclosure by Regulation A issuers and to develop rules requiring an issuer to file and distribute to prospective investors an offering statement containing specified disclosures.

Increase in Shareholder Threshold that Triggers Public Company Reporting Obligations

Title V of the JOBS Act amends Section 12(g) of the Exchange Act, which presently requires companies with more than $10 million in assets to register with the SEC as a public company when it has 500 or more shareholders of record as of the end of its fiscal year. The JOBS Act will increase the maximum number of shareholders of record that a private company can have before it must register to 2,000, so long as fewer than 500 are non-accredited investors, and excluding (i) persons who received securities pursuant to employee compensation plans in exempt transactions and (ii) "crowdfunding" investors. This will give many private companies flexibility to delay going private if that is their preference while continuing to raise private capital. Title VI of the JOBS Act also would raise the 500-shareholder threshold for banks and bank holding companies

to 2,000 shareholders and permit the termination and suspension of registration and reporting obligations of banks and bank holding companies if its shareholders of record fall below 1,200.

While the new rules will allow companies to remain private for longer periods of time, we expect that the desire of investors and employees to sell their shares, together with the relaxation of the general solicitation rules, will likely result in an increase in trading of securities of private companies on private exchanges or other secondary markets.

Timing

The timing relating to the implementation of these provisions varies as follows, subject to the SEC being able to meet certain targets set under the JOBS Act:

- the definition of an Emerging Growth Company will apply retroactively to qualifying companies that completed an IPO after December 8, 2011;
- the SEC must make the changes to Rule 506 regarding general solicitation within 90 days of enactment;
- the SEC must enact rules facilitating the crowdsourcing provisions within 270 days of enactment;
- changes to Regulation A will require SEC rulemaking, but no time limit is set by the JOBS Act; and
- changes to the number of shareholders of record for public reporting obligations would be effective upon enactment.

The JOBS Act is a Work in Progress – Stay Tuned

The JOBS Act received broad bipartisan support because of a widespread belief in both the political and business communities that excessive regulation has hampered many segments of the U.S. economy. Its proponents believe that it will lead to more startup stage companies pursuing IPOs or other capital-raising activities that will increase business growth and, in turn, create more jobs. On the other hand, there is large group of people who are critical of the JOBS Act and argue that the government rushed the legislation. For example, SEC Chairman Mary Schapiro and Commissioner Luis Aguilar and organizations such as the American Association of Retired Persons, the Center for Audit Quality, the Council of Institutional Investors and the North American Securities Administrators Association, have expressed concerns about the scope of the changes and thresholds included in the JOBS Act and the lack of investor safeguards. Many critics are also worried that the government has failed to recognize how much the JOBS Act erodes investor protections, such as Sarbanes-Oxley and the Dodd–Frank Wall Street Reform and Consumer Protection Act , that were established in response to numerous corporate and accounting scandals including Enron and WorldCom and the financial crisis, which will result in an increase in securities fraud among transactions that would fall under the modified rules established by the JOBS Act. These and other issues will need to be addressed in the final rulemaking by the SEC and the development of market practices.

We plan to continue to monitor the adoption of the JOBS Act and further rulemaking by the SEC, FINRA, NYSE/NASDAQ and the PCAOB, and will provide periodic updates. We also expect that it will take some time for investment banks to review their guidelines and policies with respect to changes in the IPO process for companies that are likely to qualify as Emerging Growth Companies and we urge companies considering an IPO to seek the views of their bankers early on in their planning process.

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