Client Advisory

Katten
Katten Muchin Rosenman LLP

Corporate/Financial Services

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The JOBS Act: Congress Overhauls Laws Governing Capital Raising for Most Issuers and Reporting for New Public Companies

Overview

On March 27, 2012, Congress passed the Jumpstart Our Business Startups Act (the JOBS Act), which President Obama has said he will sign into law. The JOBS Act includes significant reforms intended to facilitate capital raising by small businesses and has profound ramifications for private companies, broker-dealers (including underwriters, placement agents and research analysts), private investment funds (including hedge funds, venture capital funds and private equity funds), the ongoing activities of existing public companies, and "emerging growth companies," a newly created category. It represents the most comprehensive reform to the laws governing capital raising since the Securities and Exchange Commission (SEC) issued its 2005 Securities Offering Reform.

Elimination of the Ban on General Solicitation and Advertising

The JOBS Act significantly expands the options issuers (including both operating companies and investment funds) have to raise capital without registering their securities under the Securities Act of 1933 (the Securities Act). Such issuers can now engage in general solicitation and make use of general advertisements when selling to accredited investors under Regulation D, so long as they take "reasonable steps" to ensure that all purchasers are accredited investors. They can also engage in general solicitation and make use of general advertisements when selling to qualified institutional buyers under Rule 144A, so long as they take reasonable steps to ensure that all purchasers are qualified institutional buyers. This fundamental change in law means that a private operating company or investment fund can use print, broadcast or outdoor advertisements, Internet advertisements, websites without password protection and other forms of communication to market Regulation D offerings, so long as all investors who actually purchase securities in the offering are accredited investors.

The JOBS Act requires the SEC to amend Rule 506 of Regulation D and Rule 144A within 90 days of enactment to implement this change, and the SEC may impose additional requirements or issue additional interpretive guidance on what is or is not permissible in such offerings.

Reg D Offering Platforms—Exemption from Broker-Dealer Registration

In addition to eliminating the ban on general solicitation, the JOBS Act provides an exemption from broker-dealer registration for platforms that permit participants to advertise, solicit, negotiate and enter into transactions in Regulation D offerings.

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However, such platforms may neither receive transaction-based compensation for these services nor have possession of customer funds or securities in connection with transactions over the platform.

Trigger for Reporting Company Status Increased to 2,000 Holders

The JOBS Act makes it easier to avoid triggering reporting obligations under the Securities Exchange Act of 1934 (the Exchange Act) by increasing the threshold number of holders of record from 500 to 2,000 (provided that not more than 499 holders are non-accredited investors). Employees receiving issuer securities under equity compensation plans, and persons purchasing securities under the new "crowdfunding" provisions of the JOBS Act discussed below, do not count toward the threshold.

By expanding the number of permitted security holders of private companies, the JOBS Act has the potential to expand significantly the number of companies that trade on platforms devoted to private companies. This change also will permit private investment funds relying on the exclusion contained in Section 3(c)(7) of the Investment Company Act of 1940 to admit up to 2,000 investors in such funds.

Less Onerous Regulation for "Emerging Growth Companies"

The JOBS Act makes the traditional registration and initial public offering process, and public reporting and regulatory burden, less onerous for "emerging growth companies" (EGCs), which are defined to include companies that had total annual gross revenue of less than $1 billion in their most recently completed fiscal year (but not companies whose initial public offering occurred on or before December 8, 2011, so most existing public companies do not qualify as EGCs). This revenue threshold far exceeds the amount previously proposed by the SEC Advisory Committee on Small and Emerging Companies, and includes a significant number of companies that would qualify as "seasoned issuers" or "accelerated filers" under existing law. A company remains an EGC until the earliest of (i) the last day of the fiscal year in which its gross revenue exceeds $1 billion; (ii) the last day of the fiscal year following the fifth anniversary of its initial public offering of equity securities; (iii) the date on which it becomes a large accelerated filer; or (iv) the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt.

EGCs are:

- Permitted to file registration statements with the SEC for an initial public offering on a non-public or confidential basis provided that a public filing is made at least 21 days prior to the road show for the offering;
- Permitted to "test the waters" by holding meetings with accredited investors and qualified institutional buyers to evaluate interest in an upcoming initial public offering without being subject to the current restrictions on pre-offering communications;
- Required to present only two years (rather than three years) of audited financial data and selected financial information in a registration statement for an initial public offering;
- Exempt from the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002;
- Exempt from shareholder advisory votes on executive compensation and from certain disclosure requirements relating to executive compensation, and may otherwise comply only with the compensation disclosure requirements applicable to "smaller reporting companies";
- Exempt from compliance with new U.S. GAAP accounting pronouncements applicable to issuers required to file periodic reports under the Exchange Act, until such pronouncements also become applicable to private companies; and
- Exempt from any future PCAOB rules mandating auditor rotation or making modifications to the auditor report.

Investment banks and other "sell-side" analysts are now permitted to publish research reports on an EGC without any blackout period before or after its initial public offering and without having such reports deemed an offer to sell the securities of such company. Research analysts also can communicate with personnel of an EGC even if they are employed by the same investment bank that is acting or will act as underwriter for the EGC's securities.

Regulation A Expanded

The JOBS Act increases the maximum amount of proceeds that can be raised pursuant to Regulation A under the Securities Act from $5 million to $50 million, and requires the Comptroller General to report back to Congress on any necessary amendments to state "blue sky" laws regarding Regulation A.

"Crowdfunding"

The JOBS Act creates new Section 4(6) of the Securities Act (the so-called "crowdfunding" provision) which permits issuers to raise capital from non-accredited investors without registering under the Securities Act. Not more than $1 million can be raised under this section in any 12-month period. In addition, the aggregate amount raised from any one investor in any 12-month period cannot exceed the greater of :

- $2,000 or 5% of the annual income or net worth of the investor (if either the annual income or net worth of the investor is less than $100,000); or
- 10% of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000 (if either the annual income or net worth of the investor is equal to or more than $100,000).

Transactions under new Section 4(6) have to be conducted through a broker or a "funding portal" that complies with requirements to be promulgated by the SEC (which must include, among other things, registration with the SEC, making relevant disclosures to investors, and taking steps to ensure the privacy of information). See "Funding Portals" below.

Companies raising more than $500,000 under Section 4(6) in any 12-month period will be required to file with the SEC and provide investors and the broker or "funding portal" with audited financial statements. Companies raising more than $100,000 in any 12-month period but not more than $500,000 will have to provide financial statements that have been reviewed, but not audited, by an independent public accountant. Companies raising less than $100,000 in any 12-month period will need to provide tax returns for the most recent year and financial statements certified by the issuer to be true and complete in all material respects.

"Funding Portals"

A "funding portal" is defined as an intermediary for transactions involving the offer or sale of securities for the account of others pursuant to the crowding funding exemption of the Securities Act. A funding portal may not engage in traditional brokerage activities such as receiving transaction-based compensation, offering investment advice or recommendations, soliciting purchases or sales, or holding customer funds or securities.

Funding portals must register with the SEC as a funding portal or as a broker-dealer. Those entities who choose to register in the new category of funding portal will be conditionally exempt from broker-dealer registration. Registering as a funding portal will require membership with FINRA, however, and the entity will remain subject to examination by the SEC.

The JOBS Act provides that funding portals will have several responsibilities, including:

- Providing disclosures, including disclosures related to risks and other investor education materials;
- Ensuring that each investor reviews investor education information, affirms that the investor understands the risks of the investment, demonstrates an understanding of the investment risks, including the risk of illiquidity, among other things;
- Conducting due diligence on the principals of the issuer;
- Making available to the SEC and potential investors any information provided by the issuer at least 21 days before any sale;
- Ensuring that the offering proceeds are provided to the issuer when the aggregate capital raised is equal to or greater than the target offering amount, and allowing investors to cancel their commitment under terms determined by the SEC; and Ensuring that no investor in a 12-month period has exceeded the 12-month period limit on its aggregate crowdfunding investors.

Note that the SEC has the authority to impose additional requirements on funding portals.

The scope of the JOBS Act and the benefits it provides issuers and funds attempting to raise capital has attracted bipartisan support and the support of venture capitalists, entrepreneurs, and a number of business and industry groups including the United States Chamber of Commerce and the National Venture Capital Association. The JOBS Act also has attracted forceful criticism from some, including SEC Chairman Mary Schapiro and institutional investors, who fear that it goes too far in dismantling existing investor protections. Nonetheless, issuers and broker-dealers will now have the opportunity to take advantage of the relaxed regulatory requirements of the JOBS Act, and we are available to assist in responsibly doing so.

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