WILMERHALE

Congress Passes New Capital Formation Legislation

2012-03-27

Important new legislation intended to spur job creation and economic growth by improving access to the capital markets for start-up and emerging growth companies has cleared Congress. The "Jumpstart Our Business Startups Act" (JOBS Act) won final approval on March 27, 2012, and now goes to the President. The President is expected to sign the JOBS Act into law in the near future.

A summary of the JOBS Act's most significant provisions is set forth below.

IPO On-Ramp

Most notably, the JOBS Act seeks to improve access to capital for companies that qualify as "emerging growth companies" (EGCs). This new category of recently public and soon-to-be-public companies includes any issuer that had total annual gross revenues of less than $1 billion (indexed for inflation) during its most recently completed fiscal year, other than an issuer that completed its initial public offering (IPO) on or before December 8, 2011. All companies that qualify as EGCs will have the option to pursue an IPO process that is intended to be more streamlined than the currently mandated process. EGCs will have up to five years following their IPO to achieve full compliance with certain disclosure regulations and accounting and auditing standards that are currently applicable to all US public companies.[1] Most of the EGC provisions of the JOBS Act will be effective upon enactment.

During this phase-in or "IPO on-ramp" period, an EGC will enjoy the following exemptions from, and modifications of, current disclosure requirements and accounting and auditing standards:

- *Say-on-Pay, Say-When-on-Pay and Golden Parachute Exemption* - EGCs will be exempt from the requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that issuers seek shareholder approval of an advisory vote on their executive compensation arrangements, including golden parachute compensation.
- *Exemption from Pay Ratio Compensation Disclosures* - EGCs will be exempt from the Dodd-Frank requirement, which remains subject to future SEC rulemaking, to disclose the ratio of the median annual total compensation of all employees to the total compensation of their chief executive officer. EGCs are also exempt from making pay versus performance

disclosures.

- *Reduced Executive Compensation Disclosures* - An EGC will be allowed to provide scaled disclosures on executive compensation.
- *Reduced Audited Financial Statement Requirements and MD&A Disclosure* - In registration statements, EGCs will be required to provide only two years of audited financial statements (instead of three). In addition, an EGC need not present selected financial data in registration statements or Exchange Act reports, such as Annual Reports on Form 10-K, for any period prior to the earliest audited period presented in its IPO registration statement. Similarly, an EGC will only be required to include in registration statements and Exchange Act reports Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) for the fiscal periods presented in the required financial statements.
- *Delayed Application of New Accounting Standards* - EGCs will not be subject to any newly adopted or revised accounting standards unless and until these standards are deemed to apply to companies that are not "issuers" as defined in the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).
- *Internal Controls Audit Attestation Exemption* - EGCs will be exempt from the requirement under Section 404(b) of Sarbanes-Oxley that an independent registered public accounting firm attest to an issuer's internal control over financial reporting.
- *Exemption from Mandatory Audit Firm Rotation and Other PCAOB Matters* - EGCs will be exempt from any future mandatory audit firm rotation requirement and any rules requiring that auditors provide additional information about the audit or financial statements of the issuer (a so-called "auditor discussion and analysis"), which the Public Company Accounting Oversight Board (PCAOB) might adopt. (The PCAOB is considering such rules but has not yet made any proposal regarding them.) Any other new auditing standards adopted by the PCAOB will not apply to audits of EGCs unless the SEC determines that application of the new rules to audits of EGCs is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition and capital formation.
- *Additional Permitted Investor Communications, Analyst Communications and Research* - EGCs and their agents will have more freedom to communicate with potential investors that are qualified institutional buyers or institutional accredited investors, both before and after the filing of a registration statement for an offering of securities (including an IPO). Research analysts will also have greater ability to communicate with investors and with the EGC's management. Research analysts will be permitted to attend meetings with the EGC's management at which other broker-dealer personnel, including investment bankers participating in the EGC's IPO, are present, and they will be able to attend investor meetings arranged by investment bankers. Additionally, brokers-dealers, including underwriters participating in the EGC's IPO, will have more latitude to publish and distribute research reports and make public appearances regarding the company both prior to and after filing of a registration statement for an offering of common equity securities, during any prescribed post-offering blackout period or any blackout period prior to the expiration of a lock-up period.
- *Confidential Filing of Registration Statements* - EGCs will be able to submit draft

registration statements to the SEC for confidential review instead of filing them publicly on the SEC's EDGAR filing system. These confidential submissions will be exempt from Freedom of Information Act requests but will have to be filed publicly no later than 21 days before an IPO roadshow commences.

Under the JOBS Act, a company may choose to forgo any of the exemptions provided to EGCs under the JOBS Act and instead comply with the requirements that apply to an issuer that is not an EGC. An important limitation on this "opt-in" right, however, is that an EGC must choose whether it will avail itself of the exemption regarding the extension of time to comply with new and revised accounting standards at the time the company is first required to file a registration statement, periodic report or other report with the SEC. Furthermore, an EGC is not permitted to choose to comply with some but not all of the non-EGC accounting standards.

Relaxed Restrictions on Private Placements

In addition to the IPO on-ramp, the JOBS Act directs the SEC to relax restrictions on private placements for all companies (regardless of whether they qualify for EGC status) and for other participants in private placements of securities.

- *General Solicitation for Rule 506 Placements and Rule 144A Offerings* - The SEC will be required to modify Regulation D under the Securities Act within 90 days of the JOBS Act's enactment to permit general solicitation and general advertising in Rule 506 placements, provided that all purchasers in those transactions are accredited investors. The SEC will also be required to eliminate the prohibitions in Rule 144A offerings on general solicitation, general advertising and making offers to investors who are not qualified institutional buyers as long as all purchasers are qualified institutional buyers. The issuer must take reasonable steps to verify that purchasers are accredited investors or qualified institutional buyers, as applicable, using methods to be determined by the SEC.
- *Securities Platforms* - Persons will not be required to register as a broker-dealer solely because they or their associated persons maintain a "platform or mechanism" that facilitates Rule 506 offerings, co-invest in such offerings or provide ancillary services in connection with such offerings. This exemption is available only if the person or associated person does not receive compensation in connection with the purchase and sale of securities, does not hold customer funds or securities and is not subject to a "bad actor" disqualification.

Crowdfunding

Pursuant to a new exemption under Section 4 of the Securities Act, issuers will, without Securities Act registration, be able to publicly offer and sell up to $1 million of securities in "crowdfunding" transactions within a 12-month period, subject to the following restrictions:

- The amount any individual investor may invest must not exceed (1) 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, and (2) 10% of the annual income or net worth

of the investor, not to exceed a maximum aggregate investment of $100,000 by the investor, if either the annual income or net worth of the investor is equal to or more than $100,000.

- An intermediary, either a broker or "funding portal," must be used in the transaction and the intermediary must, among other things, register with the SEC, register with any applicable self-regulatory organization, ensure that investors understand the risks of the investment and ensure that investors can bear the burden of possibly losing this investment, conduct a background check, make sure that no investment limits are exceeded and comply with any other requirements the SEC may prescribe.

A "funding portal" means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to the new crowdfunding provision, that does not (1) offer investment advice or recommendations, (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal, (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal, (4) hold, manage, possess or otherwise handle investor funds or securities, or (5) engage in such other activities as the SEC, by rule, determines appropriate. Funding portals in crowdfunding transactions will not be required to register as broker-dealers so long as they remain subject to the authority of the SEC, are a member of a national securities association and meet certain requirements to be determined by the SEC.

- Issuers who offer these securities will have to file with the SEC and provide certain information to investors, the intermediary and potential investors, including an anticipated business plan, the financial condition of the issuer, a description of the intended use of the proceeds and a description of the ownership and capital structure of the issuer.
- Investors who purchase securities offered pursuant to the crowdfunding exemption would have a private right of action for rescission under Section 12(b) and Section 13 of the Securities Act for material misstatements and omissions. "Issuers" for liability purposes will include directors or partners of the issuer, the principal executive officers, principal financial officer, controller or principal accounting officer and any person who offers or sells the security in the offering.
- Issuers will need to disclose a target offering amount and the deadline to reach the target offering amount. Issuers will need to provide regular updates regarding their progress in meeting the target offering amount.
- Issuers must not advertise the terms of the offering, except for notices which direct investors to the intermediary. Issuers may not compensate, directly or indirectly, anyone for promoting the offering through the intermediary's communication channels, without taking the proper steps, which the SEC shall determine, to ensure that such promoter discloses that compensation in each promotional communication.
- Issuers must file ongoing reports with the SEC, including financial statements, subject to rules, exceptions and termination dates to be determined by the SEC.
- Issuers must also comply with such other requirements as the SEC may prescribe.
- Investors may not resell securities purchased pursuant to the new exemption for one year,

beginning on the date of purchase, except to the issuer, to an accredited investor, as part of an SEC-registered offering, or to family members or in connection with death or divorce.

- The issuer must be organized under the laws of a US state and must not already be an Exchange Act reporting company.

The JOBS Act also preempts the authority of state securities commissions to require registration and establish offering requirements for securities issued pursuant to the new crowdfunding exemption.

Within 270 days of enactment, the SEC must issue rules implementing the new exemption and establishing bad actor disqualification provisions for both issuers and intermediaries.

Higher Shareholder Threshold for Exchange Act Registration

The JOBS Act amends Section 12(g) of the Exchange Act to increase the shareholder thresholds at which an issuer must register its securities with the SEC to either (1) 2,000 persons or (2) 500 persons who are not accredited investors. Also, securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from the registration under the Securities Act shall not be considered to be held of record. Additionally, within 270 days of enactment of the JOBS Act, the SEC shall exempt, conditionally or unconditionally, securities acquired pursuant to crowdfunding transactions from the minimum shareholder threshold for Exchange Act registration of securities. Separate rules for Exchange Act registration will apply to bank holding companies.

Expansion of Regulation A

The JOBS Act amends and clarifies the SEC's existing exemptive authority under Section 3(b) of the Securities Act, effectively modifying Regulation A (Conditional Small Issues Exemption) in several ways:

- Regulation A will now permit public offerings of up to $50 million in aggregate offering amount in any 12-month period, as compared to the existing $5 million limitation.[2]
- Securities sold pursuant to Regulation A will not be "restricted securities" for purposes of the federal securities laws.
- Securities sold pursuant to Regulation A will be subject to liability under Section 12(a)(2) of the Securities Act.
- Issuers will be allowed to "test the waters" by soliciting interest prior to filing an offering statement, on such terms as the SEC prescribes.
- Issuers will be required to file audited financial statements annually with the SEC, and the SEC will be authorized to prescribe other periodic disclosure requirements (and to suspend or terminate such periodic disclosure requirements).
- The SEC will be allowed to set other terms and conditions for Regulation A offerings, including preparing and filing an offering statement and establishing "bad actor" disqualification provisions. There is no deadline in the JOBS Act for this rulemaking.
- The JOBS Act preempts the authority of state securities commissions to require registration and establish offering requirements for securities issued in Regulation A

offerings.

---

[1] A company that is an EGC on the first day of its fiscal year will no longer qualify as an EGC upon the earliest of (1) the last day of the fiscal year during which it had total annual gross revenues of $1 billion (indexed for inflation), (2) the last day of its fiscal year following the fifth anniversary of the first sale of its common equity securities in a public offering, (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 it is deemed to be a "large accelerated filer" pursuant to Rule 12b-2 under the Securities Exchange Act of 1934 (Exchange Act).

[2] Every two years the SEC will be required to review the Regulation A offering size limitation and increase it as appropriate; if the SEC decides not to increase this amount, it must report to the Committee on Financial Services of the House and the Committee on Banking, Housing, and Urban Affairs of the Senate explaining the reasoning.

Authors

Rosemary G. Reilly

PARTNER

rosemary.reilly@wilmerhale.com

+1 617 526 6633

Knute J. Salhus

RETIRED PARTNER

knute.salhus@wilmerhale.com

+1 212 230 8800

David A. Westenberg

RETIRED PARTNER

david.westenberg@wilmerhale.com

+1 617 526 6000

Thomas W. White

RETIRED PARTNER

+1 202 663 6000