SCHIFF HARDIN LLP

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Congress Passes the JOBS Act

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On March 27, 2012, the U.S. House of Representatives passed the Jumpstart Our Business Startups (JOBS) Act (H.R. 3606) by a vote of 280 to 41. The House originally passed a version of the Act on March 8, 2012, which was subsequently approved by the U.S. Senate on March 22, 2012, with the Senate amending the "crowdfunding" portion of the Act in an effort to address certain investor protection concerns raised by many commentators as well as the chairman of the SEC. The White House publicly endorsed the Act over the past few weeks, and President Obama is expected to sign the JOBS Act into law in short order.

The JOBS Act represents the most significant relaxation of the initial public offering and public company reporting requirements to be enacted in recent times. It also provides some significant revisions to certain securities laws and rules relating to access to capital in unregistered offerings. As we discuss in more detail below, the JOBS Act includes a number of important changes, including:

- Creating a transitional "on-ramp" for emerging growth companies, including phasing in compliance measures over time following the completion of an emerging growth company's IPO.

- Easing the prohibition on general solicitation, specifically requiring the SEC to (i) revise Rule 506 to make the prohibition against general solicitation contained in Rule 502 inapplicable to Rule 506 offerings where all purchasers are accredited investors and (ii) amend Rule 144A(d)(1) to provide that securities sold under Rule 144A may be offered through the use of general solicitation or general advertising.

- Raising the reporting triggers under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), from the current 500 shareholders of record to a new threshold of either (i) 2,000 shareholders of record or (ii) 500 shareholders of record who are not accredited investors, with higher thresholds for banks and bank holding companies.

- Adopting exemptions for certain "crowdfunding" transactions, including preempting state securities laws by making securities offered under exempt offerings "covered securities."

- Amending the Securities Act of 1933, as amended (the "Securities Act"), to permit companies to conduct offerings to raise up to $50 million through a process similar to current Regulation A.

IPO On-Ramp and Relaxation of Public Reporting Requirements for Emerging Growth Companies

Under Title I of the JOBS Act ("Reopening American Capital Markets to Emerging Growth Companies"), the Securities Act and Exchange Act are amended to create a new category of issuer – the "Emerging Growth Company," or "EGC." Possibly the most important feature of the JOBS Act is the way in which it eases certain aspects of the initial public offering process and relaxes certain reporting obligations for the post-IPO EGC.

Emerging Growth Company Status

The JOBS Act defines the term "emerging growth company" as an issuer that had total annual gross revenues of less than $1 billion (subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. An issuer would retain its status as an EGC until the earliest of:

- the last day of the issuer's fiscal year during which it had total annual gross revenues of $1 billion or more (as the threshold is indexed for inflation);
- the last day of the issuer's fiscal year following the fifth anniversary of the issuer's IPO;
- the date on which the issuer has, during the previous three-year period, issued more than $1 billion in non-convertible debt; and
- the date on which the issuer is deemed to be a large accelerated filer under the Exchange Act (*i.e.*, a $700 million public float).

An issuer that sold its common stock in an IPO prior to December 8, 2011 is not eligible to be an emerging growth company.

Initial Public Offering Process Reforms

The JOBS Act relaxes the IPO process for emerging growth companies in the following ways:

- **Reduced Financial Statement Requirements —** An EGC would be required to include only two years (as opposed to the three years generally required) of audited financial statements in its IPO registration statement. In any other registration statement, an EGC would not be required to provide selected financial data for any period prior to the earliest audited period presented in its IPO registration statement (as opposed to the previous five years). An EGC's MD&A will only need to cover the periods for which financial statements are included in the registration statement. These changes should reduce an EGC's offering preparation expenses as well as the time it takes an EGC to get to market.

- **Confidential Registration Statement Filing —** An EGC would be permitted to submit a draft of its IPO registration statement for review by the SEC staff on a confidential, nonpublic basis provided that the registration statement and all amendments are publicly filed at least 21 days before the date on which the issuer conducts its road show. This could be a significant benefit for an EGC that has sensitive business or financial information that it wants to keep confidential during the registration process.

- **Pre-Filing Marketing —** An EGC (or any person authorized to act on its behalf) may "test the waters" or meet with or communicate in writing with qualified institutional buyers and institutional accredited investors to gauge investor interest in its securities and offering either prior to or following the time the EGC files its IPO registration statement. Currently no efforts in the nature of an offer are permitted before a registration statement is filed.

Public Company Reporting Reforms

In addition to relaxing the IPO process, the JOBS Act reduces the reporting and compliance burdens that are imposed on the emerging growth company under the current rules following the completion of its IPO. In particular, the JOBS Act limits the reporting obligations of an EGC, for as long as the company remains an EGC, as follows:

- **Exempts EGC from Compliance with Section 404(b) of Sarbanes-Oxley —** An EGC will not be required to provide an auditor attestation of internal controls pursuant to Section 404(b) of Sarbanes-Oxley. However, Section 404(a) of Sarbanes-Oxley will apply to the EGC, so (i) the EGC's management will be required to establish, maintain and assess internal controls and (ii) the EGC's CEO and CFO will be required to provide the compliance certifications required under Sarbanes-Oxley.

- **Reduces Executive Compensation Disclosure —** An EGC will not be required to provide the full range of executive compensation disclosures required of other domestic reporting companies under Item 402 of Regulation S-K and instead is permitted to comply with the standards applicable to small business reporting companies.

- **Exempts EGC from Say-on-Pay Vote —** An EGC will not be required to hold the advisory vote on say-on-pay, say on frequency or approval of golden parachute payments until the end of the third year following the EGC's IPO or within one year of having lost its EGC status. In addition, for as long as an issuer is an EGC, it will not have to comply with the disclosures required under the Dodd-Frank Act with respect to (i) the relationship between executive compensation and the issuer's financial performance and (ii) the ratio between CEO and median employee compensation.

- **Delays Compliance with New Accounting Standards —** An EGC will not be required to comply with any new or revised financial accounting standard until the date that such accounting standard becomes applicable to private companies.

- **Exempts EGC from PCAOB Rules regarding Auditor Rotation —** An EGC will not be subject to any of the potential future rules requiring mandatory audit firm rotation or a supplement to the auditor's report that would require the auditor to provide additional information regarding the audit of the company's financial statements. An EGC will only be subject to new PCAOB rules to the extent the SEC determines that a specific requirement is necessary and appropriate for investor protection.

Research Reports Reforms

Currently, investment banks participating in an issuer's initial public offering are not permitted to publish research reports in advance of the IPO. Following the IPO, research analysts are prohibited from publishing reports until 40 days after the offering is complete (and then reporting must cease for the 15 days before and after the release or expiration of any lock-up agreement). The JOBS Act significantly changes current law and rules with respect to behavior of investment banks and analysts in connection with offerings by EGCs by:

- permitting analysts to publish or distribute research reports about an EGC that proposes to register an offering (or is in registration), even if the party producing the report is participating in the offering (and the research report will not be deemed an "offer" under the Securities Act);

- prohibiting any self-regulatory organization and the SEC from adopting or maintaining any rule or regulation that would restrict an analyst from participating in meetings with an EGC, even if such meeting includes investment banking personnel; and

- prohibiting any self-regulatory organization or the SEC from adopting or maintaining any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public appearance with respect to the securities of an emerging growth company, including any reports during any periods following the completion of an IPO. This effectively eliminates the traditional post-IPO "quiet period" with respect to an EGC IPO.

Studies Required by SEC

Under Title I of the JOBS Act, the SEC, within 180 days of enactment of the JOBS Act, is required to present to Congress its findings and recommendations following a review of Regulation S-K that is intended to comprehensively analyze the current registration requirements of Regulation S-K and determine whether these requirements can be updated to "modernize and simplify" the registration process and reduce costs and other burdens on emerging growth companies. In addition, the SEC is required, within 90 days of enactment, to conduct a study into the impact that decimalization (the quoting of stocks in one penny increments) has had on IPOs since its implementation as well as the impact of decimalization on liquidity for small- and mid-cap securities.

Effective Dates

The provisions of Title I of the JOBS Act will be effective upon enactment of the law.

Private Capital Reforms

Easing Prohibition Against General Solicitation & Amendments to Regulation D and Rule 144A

Title II of the JOBS Act ("Access to Capital for Job Creators") mandates that, within 90 days following enactment of the Act, the SEC must revise Rule 506 of Regulation D to provide that the prohibition against general solicitation or general advertising contained in Rule 502(c) shall not apply in the context of Rule 506 offerings, provided that all purchasers of the securities are accredited investors. Any such rule amendments must include a requirement that issuers must take "reasonable steps" to verify that investors are accredited investors, using such methods as determined by the SEC. Likewise, the SEC is required, within 90 days following enactment of the Act, to revise Rule 144A(d)(1) to provide that securities sold under such exemption may be offered by means of general solicitation or general advertising, provided that securities are sold only to persons the issuer reasonably believes to be qualified institutional buyers (QIBs).

The JOBS Act also creates an exemption from the broker-dealer registration requirements of Section 15 of the Exchange Act for (i) persons who maintain certain online or other platforms and engage in general advertising or general solicitation, (ii) persons who co-invest in the offered securities and (iii) persons who provide ancillary services with respect to offered securities, provided in each case that such person (and anyone associated with such person) (a) receives no compensation in connection with the purchase or sale, (b) does not have possession of customer funds or securities in connection with the purchase or sale, and (c) is not subject to statutory disqualification.

Crowdfunding

"Crowdfunding" is an outgrowth of social media that is often defined as the collective effort of people who network and pool their money and other resources together, usually via the Internet, to support a common interest or to support efforts initiated by other people or organizations. Crowdfunding can be used to accomplish a variety of goals, from supporting charities, to political campaigns, to raising funds to produce a movie, to funding a startup company or business. When crowdfunding is used for commercial goals, there is an opportunity for crowdfunding participants to share in the venture's profits – at this point, federal and state securities laws begin to apply.

Title III of the JOBS Act ("Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 or CROWDFUNDING Act") amends Section 4 of the Securities Act to create a new Section 4(6) exemption, the "crowdfunding exemption." (Recall that Dodd-Frank repealed old Section 4(5), so that former Section 4(6), which provides an exemption for sales to accredited investors, became Section 4(5).)

Offering limits. Pursuant to a new crowdfunding exemption, issuers will be able to publicly offer and sell, without registration under the Securities Act, securities in "crowdfunding" transactions, subject to the following restrictions:

- The aggregate amount sold to all investors, including any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction, is not more than $1 million.

- The aggregate amount sold to any investor, including any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction, does not exceed:

    - the greater of $2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and

    - 10%of the annual income or net worth of the investor, as applicable, up to a maximum of $100,000, if either the annual income or net worth of the investor is $100,000 or more.

- The transaction is conducted through a broker or funding portal that complies with the intermediary requirements of new Section 4A(a) discussed below.

- The issuer complies with the issuer requirements of new Section 4A(b) discussed below.

Intermediary Requirements. Pursuant to Section 4A(a), any person acting as an intermediary in a transaction pursuant to Section 4(6) must, among other things:

- register with the SEC as a broker or a funding portal;

- register with any applicable self-regulatory organization;

- provide the disclosures, including disclosures related to risks and other investor education materials, that the SEC's rules may require;

- ensure that each investor (a) reviews investor-education information, in accordance with SEC rules, (b) positively affirms that the investor understands that it is risking the loss of its entire investment, and that the investor can bear such a loss and (c) answers questions demonstrating (i) an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers, (ii) an understanding of the risk of illiquidity and (iii) an understanding of such other matters as the SEC's rules may require;

- not later than 21 days prior to the first day on which securities are sold to any investor (or such other period as the SEC may establish), make available to the SEC and to potential investors any information provided by the issuer pursuant to Section 4(6)(b);

- ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount;

- take such steps as the SEC's rules may require, including:

    - ensuring that no investor has purchased securities in Section 4(6) exempt offerings in the prior 12-month period that would exceed the investment limits set forth in the exemption;

    - taking measures to reduce the risk of fraud with respect to such transactions, including obtaining a background and securities enforcement regulatory history check on each officer, director and person holding more than 20% of the outstanding equity of every issuer whose securities are offered by such person;

    - ensuring that all investors are allowed to cancel their commitments to invest; and

    - protecting the privacy of information collected from investors.

- not compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor;

- prohibit its directors, officers or partners from having any financial interest in an issuer using its services; and

- meet any other requirements that the SEC may, by rule, prescribe.

Issuer Requirements. Pursuant to new Section 4(6)(b) of the Securities Act, in order to offer securities in a transaction pursuant to Section 4(6), an issuer must:

- file with the SEC and provide to investors and the relevant broker or funding portal certain information about the issuer, including:
    - not empty the issuer's name, legal status, physical address and Web site address;
    - the names of the directors and officers and each person holding more than 20% of the shares of the issuer;
    - a description of the issuer's business and its anticipated business plan;
    - a description of the issuer's financial condition and its financial statements (which requirements will vary depending on the size of the offering);
    - a description of the stated purpose and intended use of the proceeds of the offering as well as the target offering amount, and the deadline to reach the target offering amount (the issuer is also required to provide regular updates regarding the progress toward meeting the target offering amount);
    - the price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
    - a description of the ownership and capital structure of the issuer, including the terms of the securities of the issuer being offered; and
    - such other information as the SEC may, by rule, prescribe.
- not advertise the terms of the offering, except for notices that direct investors to the funding portal or broker;
- not compensate or commit to compensate any person to promote the offerings through communication channels not permitted by SEC rules;
- at least annually, file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer, as required by SEC rules; and
- comply with such other requirements as the SEC may, by rule, prescribe.

Exclusions. The exemption under new Section 4(6) of the Securities Act does not apply to transactions involving the offer or sale of securities by any issuer that (i) is not organized under and subject to the laws of a state or territory of the United States or the District of Columbia, (ii) is subject to the requirement to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act (that is, a company reporting under the Exchange Act), (iii) is an investment company, as defined in Section 3 of the Investment Company Act of 1940 or (iv) does not meet, or is excluded by, the rules promulgated by the SEC.

Restricted Stock and Liability. Any securities issued pursuant to new Section 4(6) of the Securities Act will be subject to transfer restrictions and may not be transferred during the one-year period beginning on the date of purchase, unless the securities are transferred (i) to the issuer, (ii) to an accredited investor, (iii) as part of an offering registered with the SEC, or (iv) to a member of the family of the purchaser, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the SEC. An investor who purchases a security in a transaction exempted by the provisions of Section 4(6) may bring an action against the issuer under Section 4A(c) for rescission or damages as a result of an alleged material misstatement or omission. Any action brought under Section 4(6)(c) shall be subject to the provisions of Section 12(b) and Section 13 of the Securities Act, as if the liability were created under Section 12(a)(2).

Blue-Sky Issues. The JOBS Act preempts state securities laws by making exempt crowdfunding securities “covered securities;” however, some state enforcement authority and notice filing requirements are retained. State regulation of funding portals is also preempted, subject to limited enforcement and examination authority.

Effective Date and Further SEC Action. The JOBS Act requires the SEC to issue rules implementing Section 4(6) and Section 4A not later than 270 days after enactment. In addition, not later than 270 days after enactment, the SEC is required to establish disqualification provisions under which an issuer or an intermediary would not be eligible to participate in a transaction in reliance on Section 4(6), based on the disciplinary history of the issuer or intermediary.

Amendments to Regulation A

Title IV of the JOBS Act (“Small Company Capital Formation”) amends Section 3(b) of the Securities Act to require that the SEC in effect amend Regulation A to, among other things, increase the aggregate offering amount of securities sold within any 12-month period under the exemption from $5 million to $50 million. The securities sold pursuant to the exemption may be offered and sold publicly, and such securities will not be restricted securities. An issuer may “test the waters” or solicit interest in its offering prior to filing any offering statement with the SEC, provided any such communications are conducted in accordance with any conditions or requirements established by rules by the SEC. The civil liability provision in Section 12(a)(2) will apply to any person offering or selling securities pursuant to the exemption.

The JOBS Act requires the SEC to adopt rules requiring that issuers taking advantage of this exemption annually file audited financial statements with the SEC. In addition, the SEC is permitted to impose such other terms, conditions or requirements the SEC may determine necessary for investor protection, including a requirement that the issuer prepare and file electronically with the SEC and distribute to prospective investors an offering statement and any related documents. The offering statement or other documents may be required to include audited financial statements, a description of the issuer's business and financial condition, a discussion of the issuer's corporate governance principles, a statement of the issuer's intended use of proceeds from the offering, and other appropriate matters. The SEC also may require an issuer to file periodic disclosures with the SEC in addition to the mandated annual filings. Disqualification provisions applicable for the exemption shall be substantially similar to the disqualification provisions adopted in accordance with Section 926 of the Dodd-Frank Act (which looks to the bad actor disqualification provisions in current Regulation A).

Under this exemption, issuers may only offer equity securities, debt securities and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities. The securities will not be considered "covered securities" for NSMIA purposes unless the securities are offered and sold on a national securities exchange, or the securities are offered or sold to a "qualified purchaser" as defined under the Act.

The Act does not establish a timeframe by which the SEC must act with respect to the rules and amendments required by Title IV of the Act.

Raising Exchange Act Registration Thresholds

Title V of the JOBS Act ("Private Company Flexibility and Growth") amends Section 12(g)(1)(A) of the Exchange Act to increase the number of shareholders of record that a non-reporting company may have before it is required to register under the Exchange Act to either (i) 2,000 shareholders or (ii) 500 shareholders who are not accredited investors. Currently, a company is required to register once it has $10 million in assets and at least 500 shareholders of record. The asset level has not been revised by the JOBS Act. Importantly, the JOBS Act not only increases the shareholder threshold, but it also revises the definition of "held of record" in Section 12(g)(5) to exclude any shareholder who received their securities only pursuant to an employee compensation plan in a transaction exempted from the registration requirements of Section 5 of the Securities Act.

Many commentators raised the question of whether "beneficial owners" should be counted rather than "holders of record" when determining if Section 12(g) required registration. A Senate amendment to make such a change was not adopted. Thus, other than the carve-out for employees receiving shares under in compensation plans, the JOBS Act does not change the current method for determining the number of "holders of record" under Section 12(g). In particular, the number of record holders of shares held through the Depository Trust Company will continue to be calculated by reference to the number of DTC participants through which shares are held, consistent with current SEC guidance, rather than the number of underlying beneficial owners.

The SEC is required to implement Title V of the JOBS Act by revising the "held of record" definition. In addition, the SEC also must also adopt certain safe harbor provisions that issuers can follow to determine whether holders of their securities received those securities pursuant to an employee compensation plan in exempt transactions. There is no specified time period required for the SEC's rulemaking under Title V.

In addition, as part of its rulemaking process, the SEC must establish rules that exclude securities sold in exempt "crowdfunding" offerings under Title III from the determination of holders of record for purposes of Section 12(g). The SEC is also required to examine its authority to enforce Rule 12g5-1 to determine if new measures are needed enforce the anti-evasion provision of Rule 12g5-1(b)(3). The SEC must submit to Congress its findings on this later point no later than 120 days after the enactment of the JOBS Act.

Title VI of the JOBS Act ("Capital Expansion") creates a new Section 12(g)(1)(B) of the Exchange Act to provide that, in the case of an issuer that is a bank or a bank holding company (each as defined in the Bank Holding Company Act), that entity must register under Section 12 of the Exchange Act not later than 120 days after the last day of its first fiscal year on which the issuer has total assets exceeding $10 million and a class of equity security (other than an exempted security) held of record by 2,000 or more persons, without further limiting the number of shareholders that are not accredited investors. In the case of a bank or a bank holding company, the issuer will no longer be subject to reporting if the number of holders falls below 1,200 persons. The SEC must issue final regulations to implement Title VI within a year of the enactment of the JOBS Act.

Conclusion

There is little doubt that the new IPO on-ramp provisions of Title I of the JOBS Act will make launching an IPO a more appealing option to a company than it has been in the past. Most notably, we see companies benefiting from the potential costs savings that may be derived from the more limited financial disclosures required by the JOBS Act, and we believe that companies will take advantage of the ability to conduct meetings with institutional accredited investors and qualified institutional buyers before launching an offering. In addition, companies that qualify as emerging growth companies will benefit from the eased reporting and compliance requirements provided by Title I. Particularly, we believe many companies will see costs savings from not being required to comply with Section 404(b) of Sarbanes-Oxley and from taking advantage of the ability to avoid extensive executive compensation disclosures. As a result, we expect the JOBS Act will have a positive impact on the number of private companies that decide to go public in the coming years. It remains to be seen, however, just how extensive this impact will be.

The JOBS Act's private offering provisions have the potential to have an even broader impact on when and how companies access capital markets because, in many cases, they apply to all companies, not only non-reporting companies. The increase in the reporting thresholds in Titles V and VI of the JOBS Act will have an immediate effect on companies currently faced with the decision of whether to go public or how to otherwise change their capital structures to avoid crossing the previous reporting thresholds. These companies may now avoid that decision altogether. Because many of the other provisions of the JOBS Act require some degree of SEC rulemaking, companies and counsel will need to remain focused on upcoming SEC releases and monitor these changes over the coming months. Regardless of how any new rules turn out, the JOBS Act will, at least to some degree, ease the path to capital for many companies, both public and private.

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