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The JOBS Act for Business Lawyers

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On April 5, 2012, President Obama signed the "Jumpstart Our Business Startups Act" (H.R. 3606; the "JOBS Act"), a bipartisan effort to ease burdens on capital formation by start-up companies. Much attention has been paid to the crowdfunding provisions of Title III of the JOBS Act and the potential it creates for fraud. (See Chuck Jaffe in the March 29, 2012, online version of the Wall Street Journal' "Market Watch" entitled: "JOBS Act benefits financial criminals" and DU Professor Jay Brown's posts in www.theracetothebottom.org starting with his March 28, 2012 post entitled "The JOBS Act and the Capital Raising Process (Crowdfunding and the Consequence of Gambling)".) The good news for business lawyers is that there is significantly more to the JOBS Act than crowdfunding. I have provided the changes enacted (or to be enacted) by the JOBS Act in the order of importance, at least in the opinion of this author.

Title II - General Solicitation Under Rule 506; Limited Broker-Dealer Exemption *(not effective immediately; dependent on SEC rulemaking)*

For business lawyers and their clients, perhaps the most significant portion of the JOBS Act is found in Title II, "*Access to Capital for Job Creators*." Section 201(a)(1) requires the Securities and Exchange Commission (the "SEC") to revise Rule 502(c) of Regulation D to permit general solicitation in Rule 506 offerings provided that the purchasers of the securities are accredited investors. The rules to be adopted by the SEC will require the issuer of the securities offered "to take reasonable steps to verify that such purchasers of the securities are accredited investors" using such methods as the SEC may determine. Some commentators have suggested that mere reliance on representations from the purchaser may not be sufficient, but the amount of issuer due diligence should be set forth in the SEC's rules. Similar changes will be made to Rule 144A, a trading exemption for qualified institutional buyers; § 201(a)(2) of the JOBS Act.

To provide some consistency in interpretation, Sections 201(1)(b) and (c) of the JOBS Act also amend Sections 4 and 5 of the Securities Act of 1933 (the "1933 Act").

The amendment to Section 5 provides that offerings under Rule 506 conducted with general solicitation will not be deemed to be a public offering for the purposes of the 1933 Act.

The amendment to Section 4 is more substantive. It provides that any person assisting an issuer with a Rule 506 offering (whether or not with general solicitation) will not be subject to registration as a broker or dealer solely because:

(i) That person provides an online (or other) platform that permits offers, sales, and negotiation of Rule 506 securities;

(ii) That person co-invests in Rule 506 securities; or

(iii) That person provides "ancillary services" in connection with a Rule 506 offering.

To be eligible for the broker-dealer exemption, the person (including any associated person) must not receive any compensation in connection with the purchase or sale of such securities, must not possess customer funds or securities, and must not be subject to the statutory disqualification defined in § 3(a)(39) of the 1934 Act (the "bad boy disqualification"). "Ancillary services" means due diligence services and document preparation services, with certain limitations.

The importance of the changes to Rule 506 is to ensure that the general solicitation provisions also pre-empt state law that may be to the contrary. 1933 Act § 18(b)(4) provides that a "covered security" includes any security issued pursuant to a rule adopted under 1933 Act § 4(2) (now § 4(a)(2)). That includes only Rule 506. As a covered security, the application of state law is limited. When effective, these general solicitation provisions are likely to significantly change the method of seeking investors by hedge funds, private equity funds and venture capital funds from the "one on one" method that is in place today.

These provisions will be defined further by SEC rulemaking to occur within 90 days (that is, before July 5, 2012).

Title I - Emerging Growth Companies *(effective immediately without SEC rulemaking)*

Title I of the JOBS Act is entitled *Reopening American Capital Markets to Emerging Growth Companies*. Title I includes amendments to the 1933 Act and to the Securities Exchange Act of 1934 (the "1934 Act"), starting with a definition of an "emerging growth company" in 1933 Act § 2(a)(19) and 1934 Act § 3(a)(80). Under these definitions, an emerging growth company has annual gross revenues of less than $1 billion (to be indexed for inflation every five years). An emerging growth company continues to be an emerging growth company until the earlier of:

- The last day of the fiscal year in which it first exceeds $1 billion (as adjusted) in gross revenues;

- The last day of the fiscal year following the fifth anniversary of the first sale of common equity under an effective 1933 Act registration statement;

- The date on which the issuer has issued more than $1 billion (not to be adjusted) in non-convertible debt during the preceding three year period; and

- The date on which the issuer becomes a "large accelerated filer" as defined in 1934 Act Rule 12b-2.

Section 102(a) of the JOBS Act goes on to exempt emerging growth companies from the requirements in 1934 Act § 14A(e) for companies with a class of securities registered under the 1934 Act to hold shareholder votes typically referred to as "say on pay," "say when on pay," and "say on golden parachutes."

Several sections of Title I of the JOBS Act are colloquially named the "IPO on-ramp" measures, intended to reverse the decrease in domestic initial public offerings ("IPOs") that have occurred over the last decade since the enactment of the Sarbanes-Oxley Act of 2002 ("SarbOx"). Section 106 of the JOBS Act permits emerging growth companies to submit 1933 Act registration statements on a confidential basis provided that the registration statement and all amendments are publicly filed at least 21 days before the issuer conducts any road show. This is intended to allow the emerging growth company to explore the IPO option without disclosing to the market the fact that it is seeking to go public or disclosing the information contained in its registration statement until the company is ready to conduct a roadshow. This will also allow the company to work through the registration statement process with the SEC staff on a "confidential, non-public" basis, although that may not lead to better public disclosure, rather this provision could result in hidden disclosure initially made in a filing with the SEC but not thereafter made publicly. The SEC will have to change its procedures to allow for these confidential submissions which will probably be on an electronic basis. Currently confidential information requests must be filed with the SEC staff in paper form under 1933 Act Rule 406 and 1934 Act Rule 24b-2.

Section 102(b)(1) of the JOBS Act amends 1933 Act § 7(a) to add a provision exempting emerging growth companies from presenting more than two years of audited financial statements in a 1933 Act registration statement or selected financial information including more than two years of numbers. This provision also exempts emerging growth companies from being required to comply with new or revised financial accounting standards until private companies (that is, those that have not had a 1933 Act registration statement declared effective or do not have a class of securities registered under the 1934 Act) are required to comply with the new or revised financial accounting standard.

The 1934 Act amendments also limit the disclosure requirements for emerging growth companies under Item 303 (*management's discussion and analysis*) and define an emerging growth company to be within the "smaller reporting company" class of issuers for the purpose of the 1934 Act reporting requirements under Item 402 of Regulation S-K (*executive compensation*) – regardless of the market cap for the emerging growth company. ("Smaller reporting companies" are defined as those with a market value of voting and non-voting common equity held by non-affiliates of less than $75 million.)

Section 103 of the JOBS Act amends § 404(b) of SarbOx (codified at 15 U.S.C. § 7262(b)) to exempt emerging growth companies from the requirement that auditors attest to the audit client's internal controls over financial reporting. Smaller reporting companies are also exempt from this requirement, but by SEC rule, not by statute.

Section 104 of the JOBS Act provides that the auditor rotation requirement imposed by § 103(a)(3) of SarbOx do not apply to emerging growth companies, although these rules do apply to smaller reporting companies. Furthermore, any new rules adopted by the Public Company Accounting Oversight Board (the "PCAOB") will not apply to emerging growth companies unless and until the SEC determines that the new rules are "necessary or appropriate in the public interest."

Among the more significant changes applicable to emerging growth companies, a changed designed to facilitate an emerging growth company's ability to test the market before announcing a registered offering, is found in Section 105 of the JOBS Act. Section 105(a) amends 1933 Act § 2(a)(3) to permit broker-dealers to publish research reports about emerging growth companies even if the broker-dealer is participating in or will participate in a registered offering for the emerging growth company. Under existing 1933 Act Rule 137, such a publication would only be permitted if the broker-dealer publishing the report were not participating in the offering and receives no direct or indirect compensation from the issuer or any broker-dealer participating in the offering. Rule 137 will not, therefore, apply to emerging growth companies. Section 105(b) of the JOBS Act amends 1934 Act § 15D similarly, preventing the SEC or FINRA from adopting any rules contrary to the Section 105(a) amendments. Section 105(d) similarly prevents the SEC or FINRA from adopting rules regulating broker-dealer communications relating to an emerging growth company after the offering period.

Section 105(c) of the JOBS Act adds a new subsection (d) to 1933 Act § 5 which permits an emerging growth company to engage in oral and written communications with qualified institutional investors and institutions (but not individuals) that are accredited investors during what is usually the "quiet period" before and after filing the registration statement but before effectiveness.

Section 108 of the JOBS Act requires the SEC to review the provisions of Regulation S-K to determine how to modernize and simplify the registration requirements for emerging growth companies. This review must result in a report to Congress within 180 days (October 2, 2012). The review may also result in changes to Regulation S-K for other companies as well.

Notwithstanding the exemptions provided to emerging growth companies in the JOBS Act, Section 107 gives emerging growth companies the right to opt out of the JOBS Act provisions and into the requirements applicable to companies that are not emerging growth companies.

Title IV – Small Company Capital Formation *(not effective immediately; dependent on SEC rulemaking)*

SEC Regulation A (adopted under 1933 Act § 3(b)) has been on the books for years, but has been little used since the late 1980s. Section 401 of the JOBS Act requires the SEC to adopt rules for a new § 3(b) exemption (referred to in some commentary as Regulation A+) for sales of up to $50 million of securities in any twelve month period (Regulation A is limited to $5 million). Similar to 1933 Act Rule 254 under Regulation A, the JOBS Act amendment specifically permits issuers utilizing this new exemption to "test the waters" before filing any offering statement and making a public offering of the underlying securities.

Perhaps the principal deficiency of Regulation A offerings was that they were not exempt from state blue sky regulation since they were not a "covered security" as defined in 1933 Act § 18(b)(4). Section 401(b) of the JOBS Act resolves this issue by defining securities issued under this exemption (1933 Act § 3(b)(2)) to be "covered securities." This may make this provision more attractive.

Titles V and VI – Shareholder Thresholds for Registration *(in material part effective immediately)*

Section 501 of the JOBS Act amends 1934 Act § 12(g)(1)(A) to require 1934 Act registration under § 12(g) when an issuer has assets of more than $10 million (formerly $1 million) and a class of security held of record by more than 2,000 persons or 500 persons who are not accredited investors (formerly 500 persons without regard to accredited investor status). Section 502 of the JOBS Act excludes from the shareholder calculation employees who received shares pursuant to an employee compensation that was exempt from registration under the 1933 Act. This could include stock issued pursuant to a variety of exemptions, including Rules 506 and 701.

A significant issue that needs to be addressed in SEC rulemaking is how an issuer can determine whether existing shareholders, who may have been accredited at the time they acquired the shares, remain accredited investors. Where transferability restrictions have been lifted under SEC Rule 144, an issuer may not have control over to whom the shares are transferred and will need to continually monitor its shareholder base – perhaps an impossible job.

Similarly, Section 601 increasing the registration threshold for banks and bank holding companies from 500 to 2,000 shareholders of record without regard to whether the shareholders are accredited investors. The threshold for terminating 1934 Act registration for banks and bank holding companies ('going dark') was increased from 300 shareholders to 1,200 shareholders of record.

The balance of Title V requires SEC rulemaking to redefine the term "held of record" under Rule 12g5-1 and study whether new enforcement provisions are necessary.

Title III – Crowdfunding *(not effective immediately; dependent on SEC rulemaking)*

Title III adds § 4(a)(6) and § 4A to the 1933 Act to establish a crowdfunding exemption from registration. Because the effectiveness of this exemption is dependent on SEC rulemaking (which must be accomplished within 270 days (January 2, 2013), this is not discussed herein but will be discussed in a future article.

The SEC's Concerns and Potential Impact of Rulemaking

The SEC's opposition to, or "concern" over, many provisions within the JOBS Act is no secret. When the Act becomes law, will this opposition effectively lead the SEC to kill provisions of the JOBS Act through the rulemaking process? In particular Title II (*General Solicitation Under Rule 506; Limited Broker-Dealer Exemption)* and Title III (*Crowdfunding*) are dependent on rules to be adopted by the SEC.

Typically, rules add detail and aid in the interpretation or implementation of the law. The SEC delay issuing the required rules or issue rules that are consistent with the letter, but not the spirit of the JOBS Act. For example, the JOBS Act requires issuers to take reasonable steps to verify that purchasers of securities are accredited in order to use general solicitations in connection with securities offerings (discussed under Title II, above). The SEC could easily make the verification requirements so onerous that compliance would be too burdensome, expensive or simply not practical.

Time (and SEC rulemaking) will tell.