JOBS Act Heralds New Era for Startup and Emerging Growth Company Financing

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As forecast, on March 27 the U.S. House passed the Senate's amended version of the Jumpstart Our Business Startups Act (the JOBS Act), clearing the way for President Obama to sign the bill into law, which he is expected to do in the coming days.

The JOBS Act's stated purpose is to spur job creation and economic growth by improving access to capital for emerging growth companies. To do so, the JOBS Act will make some of the most significant changes to the U.S. securities law landscape in over a generation.

Although opinions vary on whether the JOBS Act will indeed drive job creation and economic growth or result in adverse unintended consequences, there is a clear consensus that the impact of the JOBS Act will be fundamental and far-reaching. Future Updates will be forthcoming as the Securities and Exchange Commission (SEC) meets its rulemaking obligations under the JOBS Act.

Securities Law Changes Under the JOBS Act

The JOBS Act eases several existing securities laws and regulations to make it easier and less costly for a startup or emerging growth company to raise capital either privately or through a less-regulated initial public offering.

Relaxes 500-Shareholder Threshold for Exchange Act Registration. The JOBS Act amends Section 12(g) of the Securities Exchange Act of 1934, as amended (the Exchange Act), to raise the threshold at which an issuer must register its securities with the SEC from 500 to 2,000 shareholders of record—provided that fewer than 500 such holders are non-accredited investors—and provides that employees receiving company securities under employee benefit plans are excluded when calculating the number of record holders for this purpose.

Relaxes Requirements for New Category of "Emerging Growth Companies." To improve access to capital markets, the JOBS Act creates a new category of issuer, the "emerging growth company," with relaxed initial public offering (IPO) registration requirements.

What Is an "Emerging Growth Company"? The JOBS Act defines an emerging growth company as an issuer with less than $1 billion in total annual gross revenue during its most recently completed fiscal year. Such a qualifying company will continue to be deemed an emerging growth company until the earliest of:

- the last day of the fiscal year during which it has total annual gross revenue of $1 billion or more,
- the last day of the fiscal year following the fifth anniversary of its IPO,
- the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt, and
- the date on which it is considered to be a "large accelerated filer" under the Exchange Act (in short, when the public equity float reaches $700 million and the company has been public for at least one year).

New Category Applies Retroactively for IPOs After December 8, 2011. The JOBS Act also applies the definition of an emerging growth company retroactively to any issuer meeting the requirements so long as its IPO occurred after December 8, 2011.

Which Requirements Will Not Apply to Emerging Growth Companies? As an emerging growth company, an issuer will not have to comply with all of the requirements that would otherwise apply to a public company.

- Only Two Years of Audited Financial Statements in IPOs. An emerging growth company will be required to include only two, rather than three, years of audited financial statements in its IPO registration statement.
- No Sarbanes-Oxley Section 404 Auditor's Attestation Report on Internal Controls. An emerging growth company will not have to provide the auditor's attestation reports on internal financial reporting controls under Section 404(b) of the Sarbanes-Oxley Act of 2002.
- No New U.S. GAAP Standards. An emerging growth company will not have to comply with any new or revised financial accounting standards not applicable to private companies.
- Exempt From Some Potential New PCAOB Rules. An emerging growth company will not have to comply with any rules that the Public Company Accounting Oversight Board might adopt requiring audit firm rotation or auditor discussion and analysis of the issuer's financial statements.
• No Dodd-Frank Act Compensation Disclosure. Additionally, an emerging growth company will be exempt from the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) for separate non-binding shareholder votes on executive compensation arrangements, including golden parachute compensation, during the period of time it qualifies as an emerging growth company—and for up to three years after it no longer qualifies. An emerging growth company will also not have to provide some of the compensation disclosure that would otherwise be required under the Dodd-Frank Act, including the disclosure requirements relating to pay versus performance and to the ratio of CEO pay to median employee pay that are currently scheduled for SEC rulemaking later this year.

Removes General Solicitation and Advertising Restrictions for Certain Private Offerings. The JOBS Act removes the prohibitions against general solicitation and advertising in private offerings made pursuant to Rule 506 of Regulation D and Rule 144A, subject to certain limitations.

• For Rule 506 if All Purchasers Are Accredited Investors. For private offerings made pursuant to Rule 506, all purchasers must be accredited investors, and the issuer must take reasonable steps to verify its status as such, using methods determined by the SEC.

• For Rule 144A if All Purchasers Are QIBs. For private offerings pursuant to Rule 144A, the securities must be sold only to persons that the issuer or seller reasonably believes are qualified institutional buyers.

Creates New $1 Million Crowdfunding Exemption. To permit the sale of securities through so-called “crowdfunding” strategies, the JOBS Act creates a new exemption under Section 4 of the Securities Act of 1933, as amended (the Securities Act), permitting certain issuers to publicly offer and sell, without registration under the Securities Act, up to $1 million of securities within any 12-month period, subject to certain conditions. Public companies, companies organized outside the United States and companies that are investment companies under Section 3 of the Investment Company Act of 1940 (excluded from the definition of investment company by Section 3(b) or Section 3(c) of that Act) will not be able to rely on the new crowdfunding exemption.

• Per Investor Limit on Amount Sold. The aggregate amount sold by an issuer under the crowdfunding exemption to any investor in a 12-month period may not exceed:
  - if the investor's annual income or net worth is less than $100,000, the greater of $2,000 or 5% of the investor's annual income or net worth, or
  - if the investor's annual income or net worth is $100,000 or more, 10% of the investor's annual income or net worth, but not more than $100,000.

• Requires Additional Disclosure to SEC and Investors. Further, the JOBS Act requires issuers using the crowdfunding exemption to file with the SEC, and provide to investors and brokers or funding portals, certain information, including the issuer's anticipated business plan; a statement of its financial condition, ownership and capital structure; and a description of the intended use of the financing proceeds.

• Requires Intermediary Broker or Funding Portal Registered With SEC. The crowdfunding transaction must also be conducted through an intermediary broker or “funding portal” registered with the SEC that must, among other things, ensure that investors understand the risks of the investment and meet certain requirements.

• No Advertising Permitted. Crowdfunding issuers may not advertise the terms of the offering except for notices directing investors to the broker or funding portal.

• Purchased Securities Will Be "Covered Securities." Significantly, the JOBS Act provides that securities issued under the crowdfunding exemption are “covered securities,” thus preempting the application of state blue sky laws to securities issued through crowdfunding transactions. In addition, states may require a filing or payment of a fee with respect to securities issued under the crowdfunding exemption only if the issuer's principal place of business is located in the state or the purchasers of 50% or more of the aggregate amount of the securities sold are residents of the state.

Modifies Requirements for Regulation A Offerings. By amending Section 3(b) of the Securities Act, the JOBS Act effectively modifies the Conditional Small Issues Exemption under Regulation A in several ways.

• Raises Dollar Limit to $50 Million. These amendments raise the limit for Regulation A offerings, which are subject to fewer disclosure requirements, from $5 million to $50 million in any 12-month period.

• Purchased Securities Could Be "Covered Securities." These amendments exempt Regulation A offerings from state securities laws as "covered securities" when the securities are either
  - offered or sold through a broker-dealer or on a national securities exchange or
  - sold to a qualified purchaser, as defined by the SEC.

• Also Adds New Requirements. Additionally, the amendment to Section 3(b) adds a provision for civil liability under Section 12(a)(2) of the Securities Act for false or misleading statements or omissions in written or oral communications involved in such an offering, and it requires issuers to file audited financial statements annually with the SEC and to make certain other disclosures to investors as the SEC requires.
Implications for Private Investment Companies

In what is likely an unintended consequence, the JOBS Act makes a number of changes to traditional understandings and practices regarding what is a “public offering” under the exclusion provisions for private investment companies in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the 1940 Act). The SEC Division of Investment Management has consistently taken the position that the concept of a public offering in the 1940 Act and the Securities Act are co-terminus, and it has rejected any notion that the term “public offering” could have a different meaning under the 1940 Act than it has in the Securities Act. With the changes to the parameters of a “public offering” under the Securities Act, the JOBS Act would seem to seriously challenge that position, and the Division of Investment Management will have to decide whether to maintain its traditional co-terminus position (which would significantly liberalize the notion of “public offering” for private equity funds and hedge funds) or to take the position that the term “public offering” in the 1940 Act has a different meaning than the term “public offering” in the Securities Act.

The JOBS Act's elevation of the registration threshold under the Exchange Act from 500 to 2,000 shareholders of record will also have implications for private investment companies relying on Section 3(c)(7) of the 1940 Act, which at present has only two requirements: (a) that there be no “public offering” and (b) that offers and sales of securities be made only to qualified purchasers. Although there is no stated limit to the number of shareholders in a Section 3(c)(7) fund, the issuers of such funds have traditionally observed a 500-shareholder ceiling to avoid the registration requirements of the Exchange Act. Thus the elevated threshold for registration under the Exchange Act will effectively increase the number of potential shareholders in a Section 3(c)(7) fund from 500 to 2,000.

JOBS Act Effective Dates

While the JOBS Act's amendments establishing the so-called “on-ramp” to IPOs for emerging growth companies will take effect upon enactment, the other provisions of the JOBS Act will require extensive rulemaking by the SEC. The JOBS Act sets a tight deadline—90 days—for the SEC to amend Rules 506 and 144A to remove the prohibitions against general solicitation and advertising in private offerings pursuant to those rules. The SEC has a longer period—270 days—to make new rules to implement the JOBS Act's crowdfunding exemption, which is still an ambitious timeline. The SEC must also amend Regulation A for the new $50 million limit and revise its regulations in accordance with the JOBS Act's higher Exchange Act registration thresholds, but the Act specifies no deadlines for the SEC to implement these changes.

Additional Information

You can find the full text of the JOBS Act at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf. You can find discussions of other recent cases, laws, regulations, and rule proposals of interest to public companies on our website.

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