

securities lawflash

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Congress Passes the JOBS Act to Simplify Capital Formation

Legislation exempts emerging growth companies from certain financial disclosure and governance requirements for up to five years and provides a new form of financing to small companies.

Showing strong support for the measure, the House of Representatives on March 27 approved the Jumpstart Our Business Startups Act (the JOBS Act) by a vote of 380 to 41. The legislation was passed in the form approved by the Senate on March 22 by a vote of 73 to 26. President Obama has said that he will sign the new legislation.

The JOBS Act amends various provisions of the federal securities laws to simplify the sale of securities and increase the threshold number of record holders required to trigger the reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act). Companies that fall under the newly defined category of emerging growth company will particularly benefit from the JOBS Act's simplified financial disclosure and governance requirements. In general, under the JOBS Act, a company is defined as an emerging growth company if its initial public offering of common equity securities (IPO) was after December 8, 2011, and it had less than \$1 billion of total annual gross revenues during its last completed fiscal year. A company will no longer qualify as an emerging growth company after the earliest of (i) the completion of the fiscal year in which the company has total annual gross revenues of \$1 billion or more, (ii) the completion of the fiscal year of the fifth anniversary of the company's IPO, (iii) the company's issuance of more than \$1 billion in nonconvertible debt in the prior three-year period, and (iv) the company's becoming a larger accelerated filer, as defined under the Exchange Act.

Other important provisions of the JOBS Act include a relaxation of the general solicitation and general advertising prohibition, a new exemption for public offerings of securities in amounts that do not exceed \$50 million, and a "crowdfunding" exemption.

Following is a summary of the key provisions of the JOBS Act.

Facilitation of Capital Formation by Emerging Growth Companies

Title I, Reopening American Capital Markets to Emerging Growth Companies, will facilitate capital raising by companies that meet the definition of "emerging growth company."

Simpler Disclosure Requirements

A registration statement filed by an emerging growth company with the Securities and Exchange Commission (the SEC) under the Securities Act of 1933, as amended (the Securities Act), will differ from a registration statement filed by other companies in the following respects:

- Audited financial statements will be required for only two fiscal years in the emerging growth company's IPO filing.
- Selected Financial Data will be required for only the fiscal years that were audited in the emerging growth company's IPO filing.
- Management's Discussion and Analysis of Financial Condition and Results of Operations will be required for only the audited years.

- Executive compensation information will be presented in the limited format required for smaller reporting companies. (A smaller reporting company is a company with a public float of less than \$75 million as of the last day of its most recently completed second fiscal quarter.)

In addition, an emerging growth company will be able to submit to the SEC a draft registration statement for an IPO on a confidential basis and for a confidential nonpublic review by the staff of the SEC, provided that the initial confidential submission and all amendments thereto are publicly filed with the SEC not later than 21 days before the date on which the issuer conducts a road show.

After becoming a public company and for as long as it remains an emerging growth company, an emerging growth company will not be required to comply with the following requirements:

- The say-on-pay and say-on-golden parachute requirements adopted by the SEC pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).
- The requirement to file a report of its independent registered public accounting firm on its internal control over financial reporting, although the emerging growth company will be required to have internal control over financial reporting and its management will have to report on the adequacy of the company's internal control over financial reporting after the company has filed with the SEC its first annual report on Form 10-K.
- The rules that the SEC adopts to implement the Dodd-Frank pay-for-performance and pay equity disclosure requirements.

The JOBS Act gives an emerging growth company the option of choosing to comply with requirements that apply to public companies that are not emerging growth companies. If an emerging growth company chooses to comply with any new or revised financial accounting standard, however, it must advise the SEC of that choice and must comply with all of the financial accounting standards that are applicable to public non-emerging growth companies.

Exemption from Future PCAOB Rules

With respect to the audit of an emerging growth company, the JOBS Act exempts such company's independent registered public accounting firm from complying with any rules adopted by the Public Company Accounting Oversight Board (PCAOB) after the date of the JOBS Act's enactment, except as otherwise required by SEC rule. The JOBS Act exempts emerging growth companies from any requirement adopted by the PCAOB for mandatory rotation of the accounting firm or for a supplemental auditor report about the audit and the company's financial statements.

Testing the Waters

The JOBS Act permits an emerging growth company or its agent to communicate with potential investors that are qualified institutional buyers or institutions that are accredited investors to determine whether such persons might have an interest in a contemplated securities offering, either prior to or after the date of filing of a registration statement with respect to such offering.

Research Reports and Communications with Investors

The JOBS Act permits research reports by a broker or dealer about the emerging growth company that is the subject of a proposed public offering of common securities, regardless of whether the research report provides information "reasonably sufficient" for making an investment decision and regardless of whether such broker or dealer is participating or will participate in the offering. In addition, the JOBS Act precludes the SEC and the Financial Industry Regulatory Authority (FINRA) from adopting rules or regulations that apply in an IPO by an emerging growth company and restricts:

- Brokers, dealers, or members of FINRA from arranging for communications between securities analysts and potential investors in the IPO;
- Securities analysts from participating in certain communications with management; and
- Brokers, dealers, or members of FINRA from publishing or distributing any research reports or making a public appearance with respect to the securities of an emerging growth company within a period of time after the IPO or prior to the expiration of any restrictions on sales by the emerging growth company or its shareholders after the IPO.

Facilitation of Certain Nonpublic Offerings

The JOBS Act amends the Securities Act to provide the following:

- Offers and sales under the private offering exemption in Rule 506 of Regulation D under the Securities Act are not deemed to be public offerings as a result of general solicitation or general advertising.
- With respect to securities offered and sold in compliance with Rule 506, any person that maintains a platform or mechanism that permits the offer, sale, or negotiation of or with respect to such securities or permits general solicitation, general advertisement, or similar or related activities, or provides ancillary services with respect to such securities, is not subject to registration as a broker or dealer based on that activity alone provided that such person does not receive any compensation in connection with the purchase or sale of such securities and meets certain other conditions.

The private offering exemption in Rule 506 permits offers and sales of an unlimited amount of securities to accredited investors and not more than 35 investors who are not accredited investors. The JOBS Act requires the SEC to revise Rule 506 to permit general solicitation and general advertising in connection with such nonpublic offers provided that all purchasers of securities pursuant to the Rule 506 exemption are accredited investors. An issuer will be required to take reasonable steps to verify such status.

In addition, the JOBS Act requires the SEC to revise the exemption for resale of securities in Rule 144A under the Securities Act to eliminate the restriction on the types of persons to whom offers can be made under Rule 144A, including by means of general solicitation and general advertising, provided that sales of securities pursuant to the rule are only made to persons that the seller and its agent reasonably believe are qualified institutional buyers, as defined in the rule. Rule 144A provides that a person, other than an issuer, can offer or sell securities without regard to the registration requirements of the Securities Act provided that the person complies with the conditions in the rule.

Crowdfunding

Title III, Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, or the “CROWDFUND Act,” exempts from registration offers and sales of securities to the public that comply with new rules to be adopted by the SEC under new Section 4(6) of the Securities Act. The SEC is required to adjust the dollar amounts applicable to the crowdfunding exemption at least every five years to reflect any change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics.

Conditions to an Issuer’s Reliance on the Exemption

To rely on the crowdfunding exemption, an issuer must satisfy the following conditions:

- The issuer must be a U.S. company that is not a reporting company or an investment company, or as otherwise determined by the SEC.
- The aggregate amount of securities sold by the issuer within the previous 12-month period, including in reliance upon the exemption, cannot exceed \$1 million.

- The aggregate amount of securities sold to any investor by the issuer pursuant to the crowdfunding exemption as well as any other sales by that issuer to the investor within the previous 12-month period cannot exceed the greater of \$2,000 or, based on a certification as to annual income provided by the investor,
 - 5% of such investor's annual income or net worth, if either the annual income or the net worth of the investor is less than \$100,000; and
 - 10% of such investor's annual income or net worth, 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 greater than \$100,000.
- The offering must be conducted through a broker or funding portal that complies with new Section 4A(a) and the issuer must comply with new Section 4A(b), both described below.

Requirements Applicable to an Intermediary Participating in a Crowdfunding Offering

Section 4A(a) provides that a person that acts as an intermediary in an offering in reliance on Section 4(6) must do the following:

- Register with the SEC as a broker or a funding portal (as defined in new Section 3(a)(80) of the Exchange Act) and comply with any rules applicable to a funding portal that are adopted by the SEC.
- Register with any applicable self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act).
- Provide disclosures required by the SEC, including disclosures related to risks and other investor education materials.
- Ensure that each investor
 - reviews investor-education information, in accordance with SEC rules;
 - positively affirms that the investor understands that the investor is risking the loss of the entire investment and that the investor can bear such a loss; and
 - answers questions demonstrating an understanding of matters set forth in an SEC rule, including the level of risk generally applicable to investments in startups, emerging businesses, and small issuers, and an understanding of the risk of illiquidity.
- Take steps to reduce the risk of fraud with respect to such offerings, as established by SEC rule, 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 intermediary.
- Make available to the SEC and potential investors any information provided by the issuer pursuant to Section 4A(b), which is described below, not later than 21 days prior to the first day on which securities are sold to any investor (or such other period established by the SEC).
- Ensure that the offering proceeds are only provided to the issuer when at least the target offering amount is raised and that all investors are allowed to cancel their commitments to invest.
- Ensure that no investor exceeds the investment dollar limits discussed above.
- Protect the privacy of information collected from investors.
- Not compensate promoters, finders, or lead generators for providing personal identifying information of any potential investor.
- Prohibit its directors, officers, or partners from having any financial interest in an issuer using its services.
- Meet any other SEC requirements.

Disqualification from Crowdfunding Offerings

The JOBS Act requires the SEC to issue rules that disqualify issuers, brokers, and funding portals from participating in a crowdfunding offering under certain circumstances, including if any such person has been the subject of various types of SEC and other governmental actions.

Required Issuer Disclosures

Section 4A(b) provides that an issuer who offers or sells securities pursuant to the crowdfunding exemption must file with the SEC and provide to investors and the relevant broker or funding portal the following information:

- The name, legal status, physical address, and website address of the issuer.
- The names of the directors and officers and each person holding more than 20% of the shares of the issuer.
- A description of the business and the anticipated business plan of the issuer.
- A description of the financial condition of the issuer including, for offerings that, together with all other crowdfunding offerings within the preceding 12-month period have, in the aggregate
 - target offering amounts of \$100,000 or less, the income tax returns filed by the issuer for the most recently completed year and the issuer's financial statements certified by the CEO to be true and complete in all material respects;
 - target offering amounts of more than \$100,000 but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC; and
 - target offering amounts of more than \$500,000, audited financial statements.
- A description of the stated purpose and intended use of the proceeds of the offering.
- The target offering amount, the deadline to reach that amount, and regular updates regarding the progress of the issuer in reaching that amount.
- The price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor is provided in writing the final price and all other required disclosures and given a reasonable opportunity to rescind the purchase commitment.
- A description of the ownership and capital structure of the issuer, including how the securities being offered are being valued and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions.
- Any other information required by the SEC.

After a crowdfunding offering, the issuer must file with the SEC not less than annually and provide to investors reports of the results of operations and financial statements of the issuer, as required by SEC rule.

Restrictions on the Crowdfunding Offering Process

An issuer must satisfy the following conditions when relying on the crowdfunding exemption:

- It must not advertise the terms of the offering, except for notices that direct investors to the broker or funding portal.
- It must not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking steps required by SEC rule to ensure that such person clearly discloses any receipt, past or prospective, of such compensation.
- It must comply with any other SEC requirements.

Provisions Applicable to Purchasers in a Crowdfunding Offering

A person who purchases a security in a crowdfunding offering:

- May bring an action against the issuer alleging material misstatements or omissions and seeking to recover the consideration paid with interest less the amount of any income received thereon or for damages if the person no longer owns the security; and

- May not transfer the securities during the one-year period beginning on the date of purchase except to the issuer or an accredited investor, in a registered offering, to a member of the family of the purchaser, in connection with the death or divorce of the purchaser, or as permitted by SEC rule.

Impact of Crowdfunding Offering on Exchange Act Registration

The JOBS Act provides that investors that acquire their securities in an offering conducted pursuant to the crowdfunding exemption in Section 4(6) will not be counted for purposes of determining whether the number of record holders of a company's equity securities triggers registration under Section 12(g) of the Exchange Act.

Impact on State Law

The JOBS Act provides that sales of securities pursuant to the crowdfunding exemption will not be subject to state law registration, documentation, or offering requirements and states will have jurisdiction with respect to fraud or deceit, or unlawful conduct by a broker, dealer, funding portal, or issuer in connection with a crowdfunding offering.

Exemption for \$50 Million Offerings

Title IV, Small Company Capital Formation, amends Section 3(b) of the Securities Act to authorize the SEC to adopt a rule that exempts from registration the offer and sale within the prior 12-month period in reliance on the exemption of no more than \$50 million (subject to increase every two years, if appropriate) of equity securities, debt securities, and debt securities that are convertible or exchangeable to equity interests, including any guarantees of such securities. The new rule will also permit issuers to solicit interest in the offering prior to filing any offering statement pursuant to specified terms and conditions. The SEC may impose other terms, conditions, or requirements on the use of the exemption, including:

- The need for the issuer to prepare and electronically file with the SEC and distribute to prospective investors an offering statement containing: (i) audited financial statements; (ii) a description of the issuer's business operations, its financial condition, its corporate governance principles, and its use of investor funds; and (iii) other appropriate matters; and
- Provisions under which the exemption will not be available.

The civil liability provision in Section 12(a)(2) will apply to any person offering or selling such securities.

The SEC must require issuers that rely on this new exemption to file audited financial statements with the SEC annually after the offering and the SEC may require the issuers to make available to investors and file with the SEC periodic disclosures.

Impact on State Law

The JOBS Act provides that sales of securities pursuant to the new \$50 million offering exemption will not be subject to state law registration, documentation, or offering requirements provided the securities are offered or sold on a national securities exchange or offered or sold to a qualified purchaser, as defined by the SEC, and states will retain jurisdiction with respect to fraud and deceit, or unlawful conduct by a broker or dealer, in connection with an offering under this exemption.

Relaxation of Exchange Act Registration Requirements

Title V, Private Company Flexibility and Growth, amends Section 12(g)(1)(A) of the Exchange Act to increase the threshold number of record holders required to trigger registration under the Exchange Act from 500 record holders of a class of equity securities to either 2,000 record holders or 500 record holders who are not accredited investors, as defined by the SEC.

In addition, the JOBS Act amends Section 12(g)(5) of the Exchange Act to provide that the number of “record holders of a class of equity securities” will not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of the Securities Act, pursuant to a new SEC rule. As noted above, purchasers in a crowdfunding offering also will be exempted from being counted among the record holders covered by Section 12(g) pursuant to conditions to be included in a new SEC rule.

Title VI, Capital Expansion, amends Section 12(g)(1)(B) of the Exchange Act to provide that banks and bank holding companies must register under the Exchange Act not later than 120 days after the last day of their first fiscal year ended after the effective date of this amendment on which the issuer has total assets exceeding \$10 million and a class of equity securities (other than an exempted security) held by 2,000 or more record holders.

In addition, with respect to termination of Section 12(g) registration, Congress maintained the 300 record holder exit threshold in Section 12(g)(4) for most companies, but raised that threshold to 1,200 record holders for banks and bank holding companies. Thus, other than banks and bank holding companies, companies currently registered under Section 12(g) will not benefit from the Section 12(g) amendments.

Other Requirements of the JOBS Act

The JOBS Act requires the SEC to provide various reports to Congress, including reports on the impact of decimalization on the trading and quoting of securities and the modernization and simplification of the registration process. Further, the JOBS Act requires the Comptroller General to provide a report to Congress on the impact of state laws on Regulation A offerings.

Effective Dates

Most of the provisions of the JOBS Act are effective immediately upon enactment, including the exemption for emerging growth companies. Others require implementation by rulemaking, such as the new exemption for crowdfunding offerings and offerings that do not exceed \$50 million and the revisions to Rules 506 and 144a to permit general solicitation and general advertising. Senior SEC staff members have indicated that the staff will likely provide guidance on effective date issues shortly after enactment.

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