

April 5, 2012

*Practice Group(s):*  
*Corporate*

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

*By Phillip J. Kardis II, Robert K. Smith, and Barry J. Spatzer*

On April 5, 2012, the President signed into law the Jumpstart Our Business Startups (JOBS) Act (H.R. 3606), which incorporates several initiatives aimed at easing the regulatory burdens of traditional IPOs and private placements and generally facilitating access to the capital markets. The JOBS Act is a sweeping piece of legislation and is enormously relevant to capital markets participants. Companies and their legal and financial advisors who are considering various financing alternatives should consider the benefits of this legislation when structuring potential capital raising transactions.

### Background

The JOBS Act combines several pieces of stand-alone legislation previously approved by the House of Representatives in late 2011 (See our [Client Alert](#) dated February 8, 2012). The JOBS Act also creates a new category of issuers known as “Emerging Growth Companies” (“EGCs”), which will enjoy certain relaxed restrictions on offering communications and graduated integration (the IPO “on-ramp” provisions) into SEC reporting and governance requirements. In particular, Congress sought to make it more attractive for EGCs to go public by significantly reducing certain financial reporting and SEC disclosure requirements for these smaller, emerging companies for a specified period of time (thereby presumably saving the company substantial compliance costs).

### IPO On-Ramp

Title I of the JOBS Act relaxes certain offering, disclosure and compliance requirements for a class of companies categorized as EGCs. An EGC is defined as any issuer with less than \$1 billion in revenues for its most recently completed fiscal year.<sup>1</sup>

### IPO Reforms

Among others, Title I of the JOBS Act provides the following relief for EGCs:

---

<sup>1</sup> An issuer that initially qualifies as an EGC would continue to qualify as such until the earliest of (i) the end of the fiscal year in which its revenues equal or exceed \$1 billion; (ii) the end of the fiscal year following the fifth anniversary of the issuer's IPO; (iii) the date on which the issuer has issued more than \$1 billion in non-convertible debt over the prior three-year period; and (iv) the date on which the issuer is deemed a “large accelerated filer” under the Exchange Act (which includes issuers with at least \$700 million of public float). An issuer cannot qualify as an EGC if its IPO occurred before December 9, 2011. Thus, it appears that a newly-public company that completed its IPO during the gap between December 9, 2011 and when the legislation became law could still elect to be considered an EGC (despite that its IPO prospectus almost certainly contained all of the disclosures required of non-EGCs), although it is not clear how the market would react (given that the IPO would have been marketed on a non-EGC basis).

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

- **Audited Financial Statements**: An EGC will need to provide no more than two years of audited financial statements in its IPO registration statement. In any other registration statement, periodic or other report filed with the SEC, an EGC will not need to present selected financial data for any period prior to the earliest year for which audited financial statements were provided for its IPO.
- **Draft IPO Registration Submissions**: An EGC may confidentially submit a draft of its registration statement to the SEC for review prior to officially filing with the SEC (provided that the confidential submission and amendments thereto must be publicly filed with the SEC no later than 21 days prior to commencement of the EGC's road show).
- **Testing the Waters**: In connection with a securities offering, an EGC (including any person authorized to act on its behalf) may, either before or after filing a registration statement with respect to the offering, engage in oral or written communications with potential investors that are qualified institutional buyers ("QIBs") or accredited investors.
- **Analyst Reports**: The publication or distribution by a broker or dealer of a research report about an EGC proposing to issue common equity in a public offering will not constitute an offer to sell the security, even if the broker or dealer is participating in the offering. In addition, neither the SEC nor any national securities association may enact rules or regulations that restrict (i) a broker, dealer or member of a national securities association from publishing or distributing any research report or making a public appearance with respect to the securities of an EGC during the post-IPO or other agreed upon lock-up period, (ii) which associates of a broker, dealer or national securities association may arrange for communications between a securities analyst and a potential investor, or (iii) a securities analyst from participating in communications with an EGC's management team if such communication is also attended by associates of a broker, dealer or national securities association member in a role other than securities analyst.

### *Disclosure Reforms*

#### **New Accounting Standards**

The SEC may not require an EGC to comply with any new or revised financial accounting standard unless and until such standard applies to companies that are not subject to the Exchange Act. However, any such new standards that are applicable to a private company *will* apply to an EGC.

#### **Auditor Attestation**

An EGC's auditor would not need to provide the attestation of the EGC's internal controls required under Section 404(b) of the Sarbanes-Oxley Act of 2002 (the compliance of which is a significant regulatory cost to public companies). However, the EGC would still be required to establish and maintain internal controls and include the CEO and CFO certifications required under Rules 13a-14 and 15d-14 under the Exchange Act.

#### **Auditor Rotation**

Any existing or future rules of the Public Company Accounting Oversight Board requiring mandatory audit firm rotation or auditor discussion and analysis will not apply to an audit of an EGC.

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

### Executive Compensation Disclosure

An EGC may choose to comply with the executive compensation disclosure requirements applicable to smaller reporting companies under Item 402 of Regulation S-K, and will not be subject to the requirement under the Dodd-Frank Act to disclose the ratio of CEO compensation to median employee compensation.

### Say on Pay

An EGC will not be required to conduct the shareholder vote on executive compensation mandated under the Dodd-Frank Act until, at a minimum, three years after the first sale of the EGC's common equity in a registered offering.

The provisions of the JOBS Act relating to EGCs should increase the attractiveness of IPOs for companies meeting the applicable criteria. The benefits begin with the ability for EGCs to “test the waters” by engaging in communications with QIBs and accredited investors prior to filing a registration statement, which will facilitate the exploration of financing and liquidity alternatives, including a potential IPO, without facing the costs and embarrassment of a failed public offering. Once public, the legislation should result in meaningfully lower disclosure and regulatory burdens for EGCs than under the current regime, not the least of which being the relaxation of the auditor attestation requirements under Section 404(b) of Sarbanes-Oxley. As a result, we expect that companies meeting the EGC definition will increasingly view IPOs as both a viable source of funding and an attractive liquidity option for insiders, and as such, we expect to see an increase in the number of small IPOs compared to the diminished levels of recent years. Of course, depending on the size of the issuer, its business, operations and competitors, some issuers may elect to provide (or their underwriters may strongly suggest) the more robust traditional disclosure requirements in order to successfully market the IPO.

### Regulation D and Rule 144A Reform

Title II of the JOBS Act requires the SEC to promulgate rules providing that general solicitation restrictions do not apply to offerings conducted pursuant to Rule 506 under Regulation D, provided that the issuer takes reasonable steps to verify that each ultimate purchaser is an accredited investor.<sup>2</sup> The Act also requires the SEC to amend Rule 144A to provide that securities may be offered by means of general solicitation or general advertising, including to persons other than QIBs, so long as the issuer reasonably believes that each ultimate purchaser is a QIB. As discussed in our [Client Alert](#) dated February 8, 2012, the ability to use general solicitation and advertising in connection with large private placements may result in Rule 506 and Rule 144A becoming more desirable alternatives than registered offerings in some cases.

---

<sup>2</sup> In these types of transactions, issuers and/or their financial advisors typically receive detailed representations and warranties from potential investors regarding their accredited investor or QIB status. Presumably, this process would still be sufficient to verify the status of each ultimate purchaser in the transaction. We can help issuers and their financial advisors think through what modifications, if any, should be made to the marketing process under the new regime for private placements.

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

### Regulation A Reform

Regulation A has historically provided an exemption from registration under the Securities Act for offerings by certain non-public companies limited to \$5 million in any 12-month period. Regulation A offerings currently are not exempted from state registration requirements. Due principally to the offering size limit and state law issues, Regulation A has rarely been used historically.

Title IV of the JOBS Act eliminates a major obstacle to widespread use of Regulation A by raising the offering limit from \$5 million to \$50 million. The new exemption created by the JOBS Act, which we call “New Regulation A,” would also require the issuer to file annual audited financial statements with the SEC and permits the SEC, in its discretion, to subject issuers to ongoing disclosure requirements following the offering. Other than these changes, New Regulation A resembles the existing law in many ways, including permitting general solicitation and advertising, “testing the waters” for investor interest in advance of filing an offering document, offers and sales to retail investors (allowing a broad pool of potential purchasers) and the issuance of securities without resale restrictions.

While the JOBS Act exempts offerings under New Regulation A from state Blue Sky requirements (provided the security is listed on a national securities exchange or offered or sold to “qualified purchasers”), issuers would still be required to comply with Blue Sky laws to the extent they wish to remain private or offer securities to retail (non-qualified) purchasers. However, Blue Sky preemption was a debated issue in New Regulation A, and broader preemption remains a possibility (we note that the bill requires the Comptroller General to conduct a study on the impact of state Blue Sky laws on New Regulation A and report back to Congress on the results within three months).

### Crowdfunding

Title III of the JOBS Act creates a new exemption under the Securities Act for a type of capital raising method known as “crowdfunding.” The term generally denotes offerings in which groups of people pool small individual contributions to support the efforts of others. The new crowdfunding exemption will permit private companies to raise up to \$1 million of capital per year from large pools of retail (non-accredited) investors without complying with the full registration requirements under the Securities Act. To fall within this exemption, offerings must be conducted through a broker or funding portal, and issuers must meet certain other disclosure, operational and filing requirements. Moreover, investments by any individual are limited to an annual cap, which cap is based on the particular investor’s financial status. Securities offered under the crowdfunding exemption would be subject to transfer restrictions for a period of one year, with exceptions for transfers to accredited investors, to the issuer or pursuant to a registered offering, and for certain interfamily transfers.

While there was originally much enthusiasm for the crowdfunding concept, the final version of the legislation imposed substantial compliance and disclosure concerns for potential issuers. The final bill (unlike an earlier version) requires issuers to use a registered broker-dealer or funding portal, and potential liability and regulatory obligations for such intermediaries may ultimately be passed through to issuers. The final version of the legislation also capped the offering size for issuers not providing audited financials at \$500,000. In addition, the exemption subjects issuers to initial and ongoing disclosure requirements that, for companies of this size, will likely be viewed as onerous. Finally, while securities issued under the crowdfunding exemption will be preempted from state law as “covered securities,” certain notice filings will still be required and states will retain jurisdiction over certain fraudulent, deceitful or unlawful conduct by brokers, dealers, funding portals and issuers.

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

### Exchange Act Registration

Titles V and VI of the JOBS Act raise the shareholder thresholds under Section 12(g) of the Exchange Act before a private company is required to register as a public reporting company. Previously, a company was required to register under the Exchange Act after reaching \$10 million in assets and 500 shareholders of record, and a company so registered was permitted to deregister when its record holder count fell below 300. Title V increases the record holder threshold for Exchange Act registration to 2,000 shareholders, so long as no more than 499 holders are non-accredited. Excluded from the shareholder count entirely are holders who received their shares in an offering exempt from registration under the Securities Act and pursuant to an employee compensation plan or a crowdfunding transaction. Similarly, Title VI raises the Section 12(g) threshold for banks and bank holding companies to 2,000 record holders, but without any comparable limitation on non-accredited shareholders. The threshold for deregistration once registered will be increased to 1,200 record holders for banks and bank holding companies, and remains unchanged for other companies. It is worth noting that the JOBS Act did not specify the method for determining whether record holders are accredited, which the SEC will likely address in its rule making.

### Opportunities for Investment Banks and Other Capital Markets Participants

In addition to companies seeking to raise capital, the legislation may yield new opportunities for other participants in the capital markets. Investment banks may find it attractive to re-enter the shrinking market for small underwritten offerings, as the provisions under Titles I and IV may generate increased interest in smaller public offerings on the part of issuers and investors. In addition, the relaxed restrictions on solicitation and advertising in connection with private placements may also allow banks and other participants to add value in other ways previously not permitted under the securities laws.

In particular, we note that the new rules will likely supplant the disappearing market for small IPOs. EGCs and potential issuers under New Regulation A are likely to view the new alternatives as more attractive compared to prior options. Regional investment banks may be especially well positioned to capitalize on these new opportunities, given their existing relationships with smaller regional issuers and growth companies.

### Effectiveness

The effectiveness of the items discussed in this Alert varies. For example, while most provisions of the JOBS Act are effective immediately, others require the implementation of rule making by the SEC (such as exemptions related to crowdfunding and the Regulation A reforms). We expect the SEC will provide guidance on its rule making timeline soon.

### Next Steps and How We Can Help

If your company is seeking to raise capital, particularly a smaller company that could take advantage of many of the items discussed in this Alert, learning more about the opportunities presented under the JOBS Act should be part of any discussion of capital raising alternatives. Consider meeting now with financial and legal advisors regarding the legislation. These advisors can help you become familiar

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

with the rules and help you make a more informed decision about capital raising alternatives. For example, we can help you answer questions such as the following:

- What are the costs (e.g., Sarbanes-Oxley, audit and financial statement requirements) associated with a smaller Regulation A offering versus an IPO where the company qualifies as an EGC? For example, while an IPO for an EGC will require a prospectus, a Regulation A offering will require only an “offering circular” – What, practically, is the difference between the two, and the associated costs?
- Can a Regulation A offering be used as a “first step” toward a full IPO?
- What type of offering is likely to be commenced and completed in the most timely fashion – An IPO for an EGC, a Regulation A offering or a Regulation D offering?
- Following these various types of offerings, what will a company’s ongoing day-to-day regulatory life be like?
- Are there advantages to simply seeking a large Regulation D offering, rather than a public offering that will (even in the Regulation A context) require some level of SEC review? What are the disadvantages of a Regulation D offering? For example, securities issued in a Regulation D offering are “restricted,” meaning not freely tradable, while securities issued in traditional IPOs and Regulation A offerings are not restricted.
- My company only wants to raise a small amount of capital – Is the crowdfunding exemption a good alternative to consider?

In addition, now may be a time for financial advisors to revisit transactions that were previously shelved due to concerns that the new legislation may ease, or to target additional companies that may be in a position to take advantage of the new laws when they are enacted. Underwriters and their counsel will need to consider the new landscape when advising on the structure and/or terms of the transaction. For example, consideration should be given as to whether an IPO candidate that qualifies as an EGC should nevertheless provide information beyond what is required (and the marketing, financial and legal ramifications of that decision). In addition, the underwriting agreement in an IPO for an EGC most certainly will change in some respects (including, for example, additional representations and warranties related to any “test the waters” materials used by the issuer during the IPO process). We have significant experience in advising underwriters in securities offerings.

***Even though certain portions of the legislation require further rule making before taking effect, now is the time to become familiar with the legislation. In particular, if you have any questions about the potential benefits of the legislation, or any other matters related to raising capital in the public and private securities markets, please contact the authors listed below.***

## Capital Markets Relief: JOBS (Jumpstart Our Business Startups) Act Eases Regulatory Barriers to IPOs and Other Capital Raising Alternatives

---

### Authors:

#### Phillip J. Kardis II

phillip.kardis@klgates.com

+1.202.778.9401

#### Robert K. Smith

robert.smith@klgates.com

+1.202.778.9376

#### Barry J. Spatzer

barry.spatzer@klgates.com

+1.202.778.9261

## K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg  
Hong Kong London Los Angeles Miami Milan Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh  
Research Triangle Park San Diego San Francisco São Paulo Seattle Shanghai Singapore Spokane Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of more than 40 fully integrated offices located in North America, Europe, Asia, South America, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit [www.klgates.com](http://www.klgates.com).

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2012 K&L Gates LLP. All Rights Reserved.