# Corporate and Securities Alert:

## New Law Facilitates Corporate Capital Raising

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On March 8, 2012, the U.S. House of Representatives passed H.R. 3606 with overwhelming bipartisan support. Notwithstanding serious concerns expressed by the SEC and investor protection advocates, on March 21, 2012, the U.S. Senate passed a minimally revised version of the House bill, again with significant bipartisan support. On March 27, 2012, the House passed the Senate bill. President Obama has indicated that he will sign the bill, which could happen as early as this week. The stated purpose of this legislation, which is called the Jumpstart Our Business Startups Act (the "Act"), is to improve access to the public capital markets for emerging growth companies and thereby to increase American job creation and economic growth. The Act scales back or eliminates certain requirements contained in the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act, as well as certain other provisions of federal securities regulations.

**Reduces "Red Tape" For Emerging Growth Companies, Particularly on Their IPOs**

The Act reduces a number of existing financial disclosure, corporate governance and other regulatory burdens on a broad range of small to relatively large companies ("emerging growth companies") that have gone public since December 8, 2011, are in the process of going public or intend to go public in the future. By doing so, it seeks to increase the number of companies electing to go public and it provides those companies a transition period or "on-ramp" to the public markets, allowing them to focus resources on growth of their businesses before having to divert funds toward complying with costly regulations.

*"Emerging Growth Company" Defined to Include Perhaps 90% of Companies Going Public.* The Act's reduced requirements apply to a new category of company, an "emerging growth company," which the Act defines as an issuer of securities that had gross revenues of less than $1 billion during its most recently completed fiscal year. An issuer that is an emerging growth company as of the first day of that fiscal year will continue to maintain that status until the earliest of:

- the last day of the fiscal year in which it achieves $1 billion of gross revenues;
- the last day of the fiscal year that includes the fifth anniversary of its IPO;
- the date on which it has issued more than $1 billion in non-convertible debt during the previous three-year period; or
- the date on which it is deemed to be a "large accelerated filer" (which requires, among other things, having common equity held by non-affiliates with a market value of $700 million or more).

*Exempted from the Public Accounting Firm Attestation to Issuer Internal Controls Required by Section 404(b) of the Sarbanes-Oxley Act.* Emerging growth companies will not be required to obtain an internal controls attestation and report from their registered independent public accounting firm until such time as they cease to be emerging growth companies. For many companies going public, this will delay by at least three years the need to comply with this requirement of the Sarbanes-Oxley Act. Emerging growth companies will still be required to establish and maintain internal controls, and their CFO and CEO will still be required to certify Form 10-Q and 10-K filings.

*Confidential Submission and Review of IPO Registration Statements.* The Act provides that emerging growth company may submit confidentially to the SEC a draft of its registration statement and amendments thereto without making the documents available to the public through the SEC's EDGAR filing system. This process is conditioned upon the issuer's publicly filing its initial confidential submission (and all amendments) not later than 21 days before the date on which the issuer begins to conduct its road show. A company would effectively be able to explore the possibility of an IPO and the market's receptiveness without exposing any confidential information to its competitors or the market generally.

*Audited Financial Statements Required in IPO Registration Statements Reduced from Three Years to Two Years.* The Act provides that an emerging growth company need not present more than two years of audited financial statements in a registration statement for an IPO of common equity securities. Previously, most IPO issuers were required to present two years of audited balance sheets and three years of audited statements of operations, statements of cash flow and statements of shareholders' equity. This change is designed to reduce audit costs, but companies may find that providing the traditional level of historical financial disclosure is helpful in the IPO marketing process.

*Required "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") Disclosure Reduced.* Emerging growth companies will be required to disclose in their IPO MD&A only one annual comparison of their results of operations rather than the currently required two annual comparisons. They will also be required to discuss other financial information only for the two years for which the issuer is required to include audited financial statements.

*Required "Selected Financial Data" in Registration Statements and Periodic Reports Reduced from Five Years to as Little as Two Years.* Emerging growth companies will not be required in their registration statements or annual reports on Form 10-K to present selected financial data for any period prior to the earliest audited period presented in connection with the IPO. Thus, there would be only two years of selected financial data required in a registration statement during the year in which a company goes public and then an additional year for each subsequent year-end that passes. However, providing the traditional level of historical selected financial data may be helpful in the marketing process of the IPO.

*Reduced Disclosure Regarding Executive Compensation.* The Act permits an emerging growth company to comply with the requirements of Item 402 of Regulation S-K (Executive Compensation) by disclosing only the information currently required of a "smaller reporting company," that is a company with a market value of outstanding voting and non-voting equity held by non-affiliates of less than $75 million. Thus, an emerging growth company may omit the "Compensation Discussion and Analysis" section, provide information for three named executive officers (including the CEO but not necessarily including the CFO) rather than five and, in its Form 10-K or proxy statement, provide the summary compensation table for two years rather than three. In addition, an emerging growth company will be required to provide only the summary compensation table, the grants of plan-based awards table and the director compensation table.

*Exemptions from Say-on-Pay Vote, Certain Other Required Shareholder Actions and Certain Proxy Statement Disclosures.* The Act exempts emerging growth companies from a variety of Dodd-Frank Act requirements, including (i) the requirement that they hold a nonbinding advisory shareholder vote on executive compensation (say-on-pay vote) at least once every three years, (ii) the requirement of shareholder approval of any golden parachute payments not previously approved, (iii) the requirement that a company show in its proxy statement the relationship between executive compensation and the company's financial performance, and (iv) the requirement that a company disclose in its proxy statement the ratio of the CEO's total compensation to the median compensation of all of the company's other employees.

*Restricting the Scope of Prohibited Gun-Jumping Activity.* The Act permits emerging growth companies to engage in oral or written communications, with potential investors that are qualified institutional buyers or institutional accredited investors, in order to determine whether those investors might have an interest in a contemplated securities offering. These communications could occur either prior to or following the date of filing a registration statement. This change would allow emerging growth companies to "test the waters" and determine how attractive their proposed offering might be.

*Deferred Application of New or Revised Accounting Standards.* The Act relieves an emerging growth company from the requirement to comply with any new or revised accounting standard until the date that a company that is not an issuer is required to comply with such new or revised standard if such standard applies to companies that are not issuers.

*Eliminates Mandatory Audit Firm Rotation and Any Auditor's Discussion and Analysis.* Currently, audit partners are required to rotate off an audit client engagement after a prescribed time period. Any future rules of the Public Company Accounting Oversight Board ("PCAOB") requiring mandatory audit firm rotation or a supplement to an auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) would not apply to an emerging growth company. The PCAOB has issued concept releases suggesting both of these possibilities. Any other future rules adopted by PCAOB would also not apply unless the SEC determines that the application of future rules is necessary and appropriate for emerging growth companies.

*Ability Generally to Cherry-Pick Among the Above List of Potentially Advantageous Exemptions.* The Act permits an emerging growth company to elect to forgo any of the Act's exemptions that loosen or abolish restrictions and instead to comply with the requirements that apply to issuers that are not emerging growth companies. However, an emerging growth company that elects to comply with any new or revised accounting standard must comply with all of them.

*Research Reports Permitted During Pendency of Proposed Public Offerings.* The Act allows brokers and dealers to publish and distribute research reports about an emerging growth company that proposes to conduct a public offering of common equity even if they are participating or will participate in a registered offering of the securities of that company.

*Lifting Restrictions on Research Analyst Interactions with Investment Bankers.* The Act prohibits the SEC and other regulatory bodies from maintaining any rule in connection with an equity IPO that restricts which underwriter personnel may arrange communications between a securities analyst and a potential investor or that restricts a securities analyst from participating in a communication with the issuer's management that is also attended by underwriter personnel other than securities analysts. It is still unclear how the Act would apply to parties to the Global Settlement.

*Elimination of Restrictions on Post-Offering Research Reports and Public Appearances.* The Act allows research analysts to publish and distribute research reports and make public appearances immediately following an IPO unlike current rules that require them to delay such reports or appearances for specified time periods. Analysts would also be permitted to publish and distribute research reports at or about the time that public offering lockup agreements are expiring. This provision effectively repeals NASD Rule 2711(f), which prohibits the release of research reports within 15 days of the expiration or waiver of any lockup agreements.

*SEC Required to Review and Reduce the Disclosure Burden for Public Offerings.* The Act mandates that the SEC conduct a comprehensive analysis of the current requirements of Regulation S-K (which contains the substantive disclosure requirements for registration statements and periodic reports) to determine how these requirements might be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with these requirements for emerging growth companies. This review must be completed within 180 days of the enactment of the Act and must contain specific recommendations to Congress on how to streamline the registration process in order to make it more efficient and less burdensome for the SEC and for prospective emerging growth companies.

*SEC Required to Review Decimalization (Trading of Securities in $0.01 Increments).* The Act mandates that the SEC study (and within 90 days of the enactment of the Act submit a report to Congress on) the impact of decimalization on the number of IPOs and on liquidity for small and middle capitalization companies. If the SEC concludes that emerging growth company securities should be quoted and traded in minimum increments greater than $0.01, it is directed to adopt a rule to that effect within 180 days of the enactment of the Act. The decimalization of trading has been cited as a key factor in the decline in the number of smaller IPOs.

**Eases Some Restrictions for Private Capital Raising**

*"General Solicitation" Permitted for Some Transactions*. Most rapidly growing private companies raise capital in equity financings to small groups of venture capital funds or other sophisticated investors. These private placements must be made without any general solicitation or general advertising, such as an advertisement, article, notice or other communication published in a newspaper, magazine or similar media, or broadcast over television or radio.

The Act requires the SEC, within 90 days of the enactment of the Act, to revise Regulation D to provide that the restrictions on general solicitation and general advertising do not apply to offers or sales of securities made pursuant to Rule 506 if all purchasers of the securities are "accredited investors." The issuer will be required to take reasonable steps to verify that its purchasers are accredited investors, using methods to be specified by SEC rule. This change could permit companies to "market" their securities in a private placement through means such as advertising, press releases or news stories, so long as only "accredited investors" ultimately participate in the offering. Any issuer making such general solicitations would still need to be mindful of the content of those solicitations, as the issuer could still face potential liability for any material misstatements or omissions of material facts in connection with the sale of the securities.

*Trading Platforms*. The Act exempts platforms from registering as brokers or for trading securities that were sold in compliance with Rule 506 of Regulation D. In order to qualify for this exemption, the person(s) operating the platform (or any associated person) could not receive compensation in connection with the purchase and sale of the security, hold customer funds or securities in connection with the purchase or sale or be subject to statutory disqualification. This section could facilitate creation of additional online trading platforms for Regulation D offerings of private companies.

*"Crowdfunding."* The Act provides for a new type of transaction – "crowdfunding" – that will be exempt from the registration requirements of the Securities Act by virtue of a new Section 4(6) of the Securities Act. The exemption would apply only to sales of securities by private companies selling no more than $1.0 million of securities in any 12-month period. The maximum amount that any investor could invest with the issuer in any 12-month period is limited to:

- the greater of $2,000 or 5% of the investor's annual income or net worth if the investor's annual net income or net worth is less than $100,000; or
- the lesser of $100,000 or 10% of the investor's annual income or net worth if the investor's annual income or net worth is $100,000 or more.

The issuer would not be permitted to conduct the crowdfunding offering itself; rather it would need to use a broker or "funding portal" that meets the requirements to serve as an intermediary for the transaction. The intermediary would be required to be registered with the SEC as a broker or a funding portal, and with any applicable self-regulatory organizations. It would also need to provide disclosures relating to risks and other investor education materials and to take measures to reduce fraud, including conducting background checks on the issuer and its related persons. In addition, the intermediary would be required to ensure that investors have reviewed investor education information and understand the risks of investing in startups and illiquid securities. SEC rulemaking on these items is mandated by the Act.

Issuers relying on the crowdfunding exemption would also be required to comply with a variety of disclosure requirements, including:

- Filing with the SEC a business plan, a description of the use of the offering proceeds and a description of the capital structure of the issuer;
- Filing financial statements with the SEC, which would be required to be audited if the offering is more than $500,000;
- Disclosing risks of the investment; and
- Making any other disclosures that the SEC determines by rule.

Crowdfunding issuers would also be required to make such annual filings with the SEC and to provide such annual reports to stockholders as the SEC requires by rule. As a result, private companies using the crowdfunding exemption would be required to disclose information that they would not normally have had to disclose publicly had they relied on various forms of traditional private financing transactions.

Securities purchased in a crowdfunding would not be resold by the investors for 12 months, unless the securities were transferred to the issuer, an accredited investor or a family member or in an offering registered with the SEC.

Crowdfunding transactions would also be exempt from registration with state securities regulatory authorities. However, issuers would still face liability for any material misstatements or omissions in their disclosures. The SEC has 270 days to issue rules to implement this new exemption.

*Small Offering Exemption—Regulation A.* The Act increases the limit on the dollar amount that can be raised in an offering under Regulation A to $50 million in any 12-month period (previously the maximum was $5 million). Issuers seeking to undertake a Regulation A offering would be required to prepare and file an offering circular with the SEC, which would include audited financial statements. Issuers relying on Regulation A would also be required to file audited financial statements with the SEC.

**Significantly Increases Shareholder Threshold for Exchange Act Registration**

Section 12(g) of the Exchange Act has historically required any company that has more than $10 million in total assets and a class of equity securities "held of record" by more than 500 persons to register with the SEC and begin to file periodic reports. This effectively forced private companies that had a large number of shareholders to become public either by filing a Form 10 or by completing an initial public offering before the date on which the Form 10 filing was required. The Act does not change the level of gross assets but significantly increases the number of shareholders needed to trigger this requirement to 2,000 persons so long as fewer than 500 persons are unaccredited investors. In addition, the Act explicitly excludes from the definition of "held of record" securities held by persons who received their securities pursuant to an employee compensation plan in transactions exempted from registration under the Securities Act of 1933. In addition, within 270 days of the enactment of the Act, the SEC is directed to exempt certain securities offered pursuant to crowdfunding transactions from the "held of record" threshold. This upward revision in the number of shareholders should, at a minimum, allow companies to remain private much longer than is currently possible and would likely keep most companies from ever being forced to register as a public reporting company absent an affirmative decision to raise capital in an initial public offering (although SEC Rule 701 may still require that information be provided to employees as a condition of making equity grants available to them). This, in turn, is likely to facilitate expansion of existing markets for the trading of shares in privately held companies.

**Requires SEC to "Advertise" These Legislative Changes to Specified Type of Businesses**

Finally, the Act affirmatively requires the SEC to provide online information and conduct outreach to inform small- and medium-sized businesses, women-owned businesses, veteran-owned businesses and minority-owned businesses of the changes that are made by the Act.

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For more information on these or related matters, please contact your Fenwick securities team or the authors.

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