CAPITAL FORMATION REFORM PUSHED INTO OVERDRIVE BY THE "JOBS" ACT

March 9, 2012

To Our Clients and Friends:

Reform efforts regarding capital formation in the United States were given a forceful push towards reality with the passage by the House of Representatives on March 8 of H.R. 3606, the "Jumpstart Our Business Startups Act" (colloquially referred to as the "JOBS" Act). The JOBS Act is intended to increase capital formation, spur the growth of startups and small businesses and pave the way for more small scale businesses to go public. Before it becomes law, the Senate must approve its own version of the JOBS Act and any differences between the House vaersion and the Senate version must be resolved. The Act as passed by the House would:

- Ease access to the public capital markets for a newly created category of "emerging growth companies."
- Eliminate the prohibition against "general solicitation or general advertising" in certain private offers of securities.
- Facilitate capital formation by startup companies through "crowdfunding."
- Increase the Regulation A offering threshold for securities exempt from SEC registration from $5 million to $50 million.
- Relaxing the trigger for public company reporting requirements and regulation by increasing the shareholder of record threshold from 500 to 2,000 (or 500 non-accredited shareholders)

The JOBS Act — Background and Summary

Calls for reform of the capital formation process gained momentum steadily following the March 2011 submission of a letter regarding capital formation by Congressman Darrell Issa to Securities and Exchange Commission Chairman Mary Schapiro. The Congressman's letter included probing questions regarding the perceived decline of the domestic IPO market, the triggers for public company reporting, the ban on the use of general solicitations in private placements of securities and new capital raising techniques, including crowdfunding. In an April response to the Congressman's letter, Chairman Schapiro indicated that the SEC was reviewing these and other areas of concern. Since then, a smorgasbord of legislative measures was

introduced in and/or approved by Congress and, on February 28, House Majority Leader Eric Cantor introduced the JOBS Act.

The JOBS Act is a legislative package of six bills, each of which enjoyed strong bipartisan support in the House. Summarized below are the key provision of the JOBS Act.

Title I — Reopening American Capital Markets to Emerging Growth Companies Act. Currently, every IPO issuer must comply on an equal basis with a full pallet of regulatory requirements both during and following the IPO process, and certain of these requirements may be more or less burdensome and costly depending upon an IPO issuer's size. The Title I would alter this paradigm by permitting a new category of issuer, defined as an "emerging growth company," to utilize scaled and more flexible regulatory requirements during the IPO process and, through the end of a transition period, post-IPO.

Emerging Growth Companies. Title I defines an emerging growth company as a company with less than $1 billion in annual gross revenues during its most recently completed fiscal year until the earliest of:

- the last day of the fiscal year during which it had total annual gross revenues of $1 billion or more;
- the last day of the fiscal year following the fifth anniversary of its IPO;
- the date on which it had, during the pervious three-year period, issued more than $1 billion in non-convertible debt; or
- the date on which it is deemed to be a "large accelerated filer" (*i.e.*, a company with an unaffiliated float of at least $700 million).

Only companies that complete their IPO after December 8, 2011 may utilize the Title I exemptions for emerging growth companies.

Facilitating the IPO Process for Emerging Growth Companies. Title I would facilitate the IPO process for emerging growth companies in several ways. First, emerging growth companies would be permitted to submit a draft of its IPO registration statement for confidential nonpublic review by the SEC. This would presumably foster greater dialogue between such companies and the SEC staff on sensitive issues and would enable them to first file their IPO registration statement publicly with the benefit of prior SEC review. Second, an emerging company's IPO registration statement would be required to include:

- only two years of audited financial statements (instead of three);
- period-over-period MD&A discussion covering only the two-year audited fiscal periods (and any requisite interim periods) required to be included in the registration statement; and
- the scaled executive compensation disclosure, including the CD&A, that satisfies the requirements applicable to smaller reporting companies (*i.e.*, those companies with a public float of less than $75 million).

Title I would also make it easier for participants in the offering process to communicate with investors. Marking a significant departure from current rules and regulations designed to prevent "gun-jumping," emerging growth companies and their underwriters would be permitted to communicate orally and in writing with qualified institutional buyers or accredited investors during the pre-filing and post-filing period "to determine whether such investors might have an interest in [the] contemplated securities offering." In addition, brokers and dealers would have significantly more freedom to publish research about an emerging growth company and engage in communications with the company and investors generally, as Title I would:

- permit broker and dealers, including participating underwriters, to publish research reports about an emerging growth company prior to, during and immediately following its IPO; and
- eliminate certain restrictions on communications between securities analysts and both potential investors and management of emerging growth companies.

Simplifying Post-IPO Life, Temporarily. Title I would postpone compliance with certain post-IPO regulatory requirements that proponents of capital formation reform view as overly burdensome and costly for newly public companies, particularly smaller issuers. Through the end of the transition period discussed above, emerging growth companies would be:

- permitted to include scaled executive compensation disclosure applicable to smaller reporting companies in post-IPO registration statements and reports filed with the SEC (*e.g.*, the annual proxy);
- required to present selected financial data in any post-IPO registration statement and reports filed with the SEC only beginning with the earliest period presented in the IPO registration statement;

- exempt from the auditor attestation requirements of Sarbanes-Oxley 404(b) regarding internal control over financial reporting;
- exempt from new or revised financial accounting standards;
- exempt from specific accounting and audit standards, including rules requiring mandatory audit firm rotation and any rule requiring the addition of an auditor discussion and analysis to the audit report; and
- exempt from the requirements relating to say-on-pay votes and say-on-golden-parachute votes and the disclosure of pay versus performance and the ratio of CEO-to-worker pay compensation.

An emerging growth company may pick and choose among the exemptions provided under Title I; however, to the extent that an emerging growth company chooses to opt out of the exemption relating to new or revised financial accounting standards, it must comply will all such standards on the same basis as a non-emerging growth company through the end of the transition period.

Title II — Access to Capital for Job Creators Act. Section 4(2) of the Securities Act of 1933 provides a statutory exemption for "transactions by an issuer not involving any public offering." Unfortunately, "public offering" is not defined anywhere in the Securities Act. While neither the Securities Act nor its legislative history states or implies that the use of general solicitation or general advertising is forbidden in private placements, practitioners and market participants have generally read the prohibition into practice (including Rule 144A offerings) based on judicial decisions and SEC releases and by analogy to the specific prohibition in Regulation D. Title II would significantly alter the manner in which a significant portion of unregistered offerings are conducted by amending Rule 144A to provide that securities sold pursuant to the rule may be offered to persons other than qualified institutional buyers (QIBs), including by means of general solicitation or general advertising so long as the securities are sold only to persons reasonably believed to be QIBs. Title II also (i) eliminates the prohibition in Regulation D for offers and sales of securities that exceed $5 million to the extent that all purchasers are accredited investors and (ii) subject to certain requirements, exempts from registration as a broker dealer any person that:

- facilitates such Regulation D offerings through a platform or mechanism (whether online, in person or otherwise) that permits general solicitations, general advertisements or similar or related activities;
- any associated person that co-invests in the Regulation D securities; and

- any person that provides certain "ancillary services" in connection with such Regulation D offerings, including due diligence services and the provision of standardized transactional documentation.

Most significantly, with the elimination of the ban on general solicitation or advertising in Rule 144A and such Regulation D offerings, companies would presumably be free to solicit investor interest widely and publicly (*e.g.*, through full-page advertisements in The New York Times or blast e-mails via Twitter) but would still be required to follow reasonable policies and procedures in order to ascertain the identity and nature of the purchasers of any offered securities.

Title III — Entrepreneur Access to Capital. Title III would facilitate the relatively new method of capital raising known as crowdfunding. In short, crowdfunding is a form of capital raising whereby groups of small investors pool money to fund companies in need of capital (generally small and early stage companies). Title III would provide an exemption from registration under the Securities Act for securities offered and sold in transactions by an issuer if the aggregate amount of securities sold during the previous 12 months in reliance on the exemption:

- by the issuer is: (i) $1 million or less or (ii) $2 million or less if the issuer provides potential investors with audited financial statements; and
- to any investor does not exceed the lesser of (i) $10,000 and (ii) 10% of such investor's annual income.

Title III includes a list of specific action items required of the issuer or, if the crowdfunding is intermediated, the intermediary, that are intended to address the potential for fraud and other abuses associated with a quickly growing and potentially unsophisticated shareholder base, including requirements to:

- convey specified information to potential investors (*e.g.*, of the speculative nature of the investment);
- take "reasonable measures" to reduce the risk of fraud with respect to the transaction;
- have potential investors answer questions intended to demonstrate such investors' appreciation of the risks associated with the investment;
- establish certain controls and procedures to reduce fraud; and
- provide investor access to ongoing information about the issuer.

Securities sold through a crowdfunding would be subject to a one-year statutory lockup unless sold to the issuer of the securities or an accredited investor and would be exempt from State securities laws (other than state enforcement actions with regard to funding participants). Holders of securities issued pursuant to a qualified capital raise would not count toward the Section 12(g) shareholder of record threshold. Finally, an intermediary would not be required to register as a broker solely by reason of participation in the crowdfunding transaction.

Title IV — Small Company Capital Formation. The current exemption for small issuances of securities under the Securities Act, effected through Regulation A, is of somewhat limited utility given the current $5 million cap on offering size. Title IV would significantly increase the utility of the exemption by increasing the aggregate amount of all securities offered and sold within the prior 12-month period in reliance on the exemption to $50 million. With its upsized cap, a revamped Regulation A could appeal to private companies in need of capital at various stages of their development, due to:

- a lack of strict issuer liability for material misstatements or omissions in the offering document;
- the ability to test the market prior to filing any offering document with the SEC;
- free transferability of Regulation A securities under Rule 144 (other than for affiliate securities);
- more limited disclosure requirements applicable to the offering document (compared to a traditional Securities Act registration statement); and
- potentially more limited "periodic" disclosure requirements (Title IV requires only that audited financial statements be publicly filed and delegates discretion to the SEC to require additional periodic disclosure).

To the extent that Regulation A securities are offered or sold on a national securities exchange or offered or sold to "qualified purchasers" as defined by the SEC, they would be exempt from State securities laws.

Title V — Private Company Flexibility and Growth. Under Section 12(g) of the Securities Exchange Act of 1934, a company with more than 500 shareholders of record (and more than $1 million in assets) must comply with all of the statutory and regulatory requirements applicable to public companies, including the registration and disclosure requirements under the Federal securities laws and the requirements of the Sarbanes-Oxley Act of 2002. The 500 shareholder threshold is a decades-old threshold and has come under pressure as certain companies have

granted equity deep into their employee ranks (as was the case with Facebook) and liquidity in private company shares has increased, particularly with the development of private trading platforms and exchanges. Title V would revise the Section 12(g) such that a company would become subject to public company requirements if it had $10 million in assets and a class of equity security (other than an exempted security) held of record by either (i) 2,000 persons or (ii) 500 person who are not accredited investors. Most importantly, employees holding only exempt equity compensation would be excluded from the shareholder calculation. The combination of the increase in the shareholder trigger and the exclusion for employees would be significant developments in the Federal securities laws, as accredited investors and exmployees may be the only shareholders in many private companies, or at least may predominate over unaccredited, non-employee investors.

Title VI — Capital Expansion. Attempting to address a perceived lack of funding alternatives for community banks, Title VI would provide banks (including bank holding companies) with specific additional cushion under Section 12(g) of the Exchange Act by quadrupling the number of shareholders of record necessary to trigger the public company registration, disclosure and other requirements from 500 to 2,000. Title VI would also quadruple the threshold for de-registration as a public company from 300 to 1,200 shareholders of record.

Final Thoughts

While not free from doubt, given the fact that analogous bills have been introduced in the Senate (*e.g.*, the Schumer-Toomey bill, S. 1933), the JOBS Act enjoyed strong bi-partisan support and the fact that members of Congress (and no doubt the President) would welcome an easy legislative win, it seems more likely than not that the JOBS Act will become law sometime in the near future. SEC rulemaking then would follow enactment as many provisions of the Act require or permit the SEC to engage in rulemaking to carry out the changes in law.

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We will continue to report on relevant legislative and regulatory developments. In the meantime, please do not hesitate to call us with any questions.

Matthew E. Kaplan
+1 212 909 7334
mekaplan@debevoise.com

Alan H. Paley
+1 212 909 6694
ahpaley@debevoise.com

Peter J. Loughran
+1 212 909 6375
pjloughran@debevoise.com

Ethan T. James
+1 212 909 6562
etjames@debevoise.com

Paul M. Rodel
+1 212 909 6478
pmrodel@debevoise.com

Steven J. Slutzky
+1 212 909 6036
sjslutzky@debevoise.com