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CLIENT UPDATE

SENATE AGREES WITH HOUSE ON NEED FOR CAPITAL FORMATION REFORM AND PASSES THE "JOBS" ACT

March 23, 2012

To Our Clients and Friends:

On March 22, the Senate passed H.R. 3606, the Jumpstart Our Business Startups Act (colloquially referred to as the "JOBS" Act), with only modest amendments to the House version of the Act. As we reported to you on March 9 in connection with House passage, 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 differences between the House version and the Senate version must be resolved. The Act as passed by both houses of Congress 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 start-up companies through "crowdfunding."
- Increase the Regulation A offering threshold for securities exempt from SEC registration from $5 million to $50 million.
- Relax 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 solicitation in private placements of securities and new capital raising techniques, including crowdfunding. In April, Chairman Schapiro responded that the SEC was reviewing these and other areas of concern. Since then, a smorgasbord of related legislative measures was introduced in and/or approved by Congress. On March 9, the House passed the JOBS Act (a legislative package of six bills), and

on March 22 the Senate passed the House version of the JOBS Act with certain amendments to the crowdfunding provisions.

Summarized below are the key provision of the JOBS Act (title references are to those included in the House version of the 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. Title I would alter this paradigm by permitting a new category of issuer, defined as an "emerging growth company," to utilize less burdensome regulatory requirements during the IPO process and during a transition period after its 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 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 has, during the previous 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 IPOs 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, an emerging growth company would be permitted to submit a draft of its IPO registration statement for confidential non-public review by the SEC. This would presumably foster greater dialogue between emerging growth 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 the currently required three);
- selected financial data only beginning with the earliest period presented in the IPO registration statement;
- 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
- 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 Federal securities law 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 institutions that are accredited investors during the pre-filing and post-filing periods "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 described above, emerging growth companies would be:

- permitted to include executive compensation disclosure applicable to smaller reporting companies in post-IPO registration statements and reports filed with the SEC (*e.g.*, the annual proxy);

- permitted to present selected financial data in any post-IPO registration statement and reports filed with the SEC 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 applicable only to public companies;
- 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 elects to opt out of the exemption relating to new or revised financial accounting standards, it must comply with all such standards on the same basis as a non-emerging growth company through the end of the transition period and it may not change its election.

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 requiring the SEC to revise 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 similarly requires the SEC to revise Rule 506 of Regulation D to eliminate the prohibition on general solicitation and general advertising in Regulation D for offers and sales of securities that exceed $5 million to the extent that all purchasers are accredited investors (*i.e.*, Rule 506 offerings). Title II also includes provisions

that may foster the development of methods for broadly marketing Rule 506 offerings by exempting from registration as a broker or dealer:

- any person that facilitates Rule 506 offerings through a platform or mechanism (whether online, in person or otherwise) that permits general solicitations, general advertisements or similar or related activities;
- any person or any associated person that co-invests in securities sold in Rule 506 offerings; and
- any person or any associated person that provides certain "ancillary services" in connection with Rule 506 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 Rule 506 offerings, companies would presumably be free to solicit investor interest widely and publicly (*e.g.*, through full-page advertisements in *The New York Times*, blast e-mails or even 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. The SEC will be required to issue rule revisions to eliminate the ban on general solicitation and general advertising in Rule 144A and Rule 506 within 90 days of enactment of the JOBS Act.

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 as passed by the House and the Senate differ in several ways as summarized below.

Title III, as passed by the House, would provide an exemption from registration under the Securities Act for securities offered and sold in transactions by an issuer (either directly or through an intermediary) 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 percent of such investor's annual income.

The Senate version would exclude from the scope of the exemption transactions involving the offer or sale of securities by an issuer that is: (i) not organized under and subject to the laws of a State or territory of the United States of the District of Columbia, (ii) subject to the reporting requirements of the Exchange Act or (iii) an investment companies or another specifically excluded issuer. The Senate version would also:

- limit issuances of Title III securities by the issuer (or any person controlled by or under common control with the issuer) to $1 million during any 12-month period;
- impose tighter caps on the aggregate amount of such securities that may be sold to any particular investor; and
- require the issuer to provide investors with financial statements which would have to be audited to the extent that the issuer has issued more than $500,000 of securities under Title III in the preceding 12-month period.

Most significantly, the Senate version would require that any securities issued under Title III be offered and sold through a registered broker or a "funding portal" (as defined in the Senate version of the Act).

Title III includes a list of specific action items required of the issuer and any financial intermediary that facilitates a crowdfunding 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 affirmative steps 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.

The Senate version of Title III includes additional requirements of issuers and intermediaries in this regard and includes a specific provision imposing liability for material misstatements or omissions in connection with the offer or sale of crowdfunding securities.

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. The Senate version would also explicitly permit transfers as part of an SEC registered offering and transfers to a member of the purchaser's family in connection with the death or divorce of the purchaser. Crowdfunding securities would be exempt from State securities laws (other than state enforcement actions with regard to funding participants), and holders of securities issued pursuant to a qualified capital raise would not count toward the Section 12(g) shareholder of record threshold. Finally, under the House version of Title III, 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 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, pursuant to SEC rule, more than $10 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 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 persons 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 employees 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 by a bank as a public company from 300 to 1,200 shareholders of record.

Final Thoughts

Given the limited differences between the House and Senate version, we expect the Act to become law in the near future. Many provisions of the Act require or permit the SEC to engage in rulemaking to carry out the changes in law and SEC rulemaking will follow enactment. Finally, it is important to keep in mind that state securities laws will need to be considered notwithstanding the changes to the Federal securities laws effected by the Act.

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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.

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