Client Alert

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

CURRENT ISSUES RELEVANT TO OUR CLIENTS APRIL 5, 2012

President Signs JOBS Act: Eases Capital Raising Restrictions and IPO Hurdles for Smaller Companies and Private Funds

President Obama signed into law today the Jumpstart Our Business Startups Act (the "JOBS Act"), which is designed to facilitate public and private company access to the capital markets through a number of separate initiatives. These provisions are expected to have a favorable impact on smaller private companies and, in some instances, private investment funds.

The JOBS Act:

- eases the regulatory burdens and costs associated with IPOs for a new class of issuers called "emerging growth companies";
- eliminates the general solicitation and advertising prohibition for offerings made pursuant to Rule 506 of Regulation D (the most popular private placement exemption);
- exempts certain "crowdfunding" transactions from registration under the Securities Act of 1933 (the "Securities Act");
- exempts securities offerings of up to $50 million from Securities Act registration;
- increases the threshold for registration and reporting under the Securities Exchange Act of 1934 (the "Exchange Act"); and
- exempts certain intermediaries participating in Rule 506 and crowdfunding offerings from federal broker-dealer registration.

IPO Process Made Easier for "Emerging Growth Companies"

The JOBS Act streamlines the initial public offering ("IPO") process for companies falling into a new category of issuer known as "emerging growth companies" ("EGCs") by easing certain regulatory requirements for up to five years. To qualify as an EGC, the issuer must have had total annual gross revenues of less than $1 billion during its most recently completed fiscal year.

Relief from Certain Public Company Requirements

Effective immediately, an EGC will be able to benefit from the various new forms of relief available to it for as long as it maintains its status as an EGC, including:

- *Reduced Requirements Relating to Executive Compensation:* EGCs are exempt from holding advisory shareholder votes on executive compensation and golden parachutes as set forth under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). EGCs are also exempt from certain Dodd-Frank Act executive compensation disclosure requirements. For example, information on the relationship between compensation paid and the financial performance of the issuer, and the ratio of median total compensation of all employees to that of the chief executive officer, among other things, are not required to be disclosed.
- *Reduced Requirements Relating to Audited Financial Statements and Associated Disclosure*: EGCs are allowed to present two (rather than three) years of

audited financial statements in its IPO registration statement and are not required to present selected financial data or management's discussion and analysis for any period prior to such two-year period in any registration statement or periodic or other reports.

- *Exemption from Providing Auditor Attestation Reports*: EGCs are exempt from the auditor attestation and reporting requirement on the company's internal control over financial reporting under Section 404 of the Sarbanes Oxley Act of 2002.

- *Exemption from New Accounting Standards and Rules:* EGCs are not required to comply with any new or revised financial accounting standards until a private company would be required to comply with such standards. EGCs are also exempt from any rules that the Public Company Accounting Oversight Board may adopt requiring mandatory audit firm rotation or certain auditor's report supplements.

Maintaining EGC Status and Other IPO-Related Reforms

Once an issuer qualifies as an EGC, it maintains such status until the earliest of (i) the last day of the fiscal year during which it had total annual gross revenues of $1 billion or more; (ii) the last day of the fiscal year following the fifth anniversary of its IPO; (iii) the date on which the issuer has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or (iv) the date on which the issuer is deemed to be a "large accelerated filer" (i.e., public float of equity securities of $700 million). An issuer is not eligible for EGC status if it conducted its IPO on or before December 8, 2011. Any EGC seeking to go public may submit a draft registration statement for confidential, nonpublic review by the staff of the Securities and Exchange Commission (the "SEC"). Thereafter, it will be required to publicly file its registration statement, and any amendments thereto, at least 21 days before conducting a road show.

An EGC, or any person authorized to act on its behalf, may also engage in oral or written communications with qualified institutional buyers or institutional accredited investors before filing a registration statement in order to determine whether such investors might have an interest in the contemplated offering. Broker-dealer research reports relating to an EGC that is the subject of a proposed public offering and securities analyst communications with the management of an EGC are also subject to fewer restrictions than those applicable to larger issuers.

Prohibition on General Solicitation and Advertising Removed from Reg D Rule 506

The JOBS Act directs the SEC to revise Rule 506 of Regulation D under the Securities Act ("Rule 506") to remove the prohibition against general solicitation and general advertising, provided that all of the purchasers of the securities so offered are accredited investors, and to require the issuer to take reasonable steps using methods to be prescribed by the SEC to verify that purchasers of the offered securities are indeed accredited investors. The JOBS Act also directs the SEC to revise Rule 144A under the Securities Act to permit the use of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe to be a qualified institutional buyer. The SEC must adopt these revisions within 90 days.

Practical Considerations for Private Funds

The exact scope and application of these proposed changes cannot be precisely defined until the revised rules are adopted by the SEC. Nonetheless, the elimination of the existing prohibition on general solicitation and advertising is expected to result in significant opportunities for private companies to reach a much larger and broader potential investor audience. As such, revised Rule 506 could potentially have far-reaching implications for private funds relying on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"). Among other things, these sections prohibit a fund from making a public offering of its securities. The JOBS Act does not amend this prohibition. As a result, there could be some question as to whether private funds engaging in general solicitation or advertising pursuant to revised Rule 506 would continue to satisfy the Investment Company Act private offering requirement. The JOBS Act appears to resolve this uncertainty by explicitly providing that offers and sales exempt under Rule 506 "shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." Moreover, the SEC has taken the position in the past that an offering qualifies as nonpublic for purposes of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act if the offering qualifies as a nonpublic offering under Rule 506.

New Exemption from Securities Act Registration Created for "Crowdfunding" Transactions

The JOBS Act allows companies to pool money from individuals with common interests and to issue shares in exchange for crowd-funded capital. SEC exemptions under Regulation A and many state securities laws impose certain filing and disclosure requirements that have traditionally presented hurdles for crowdfunding initiatives. The new registration exemption under the federal securities laws for crowdfunding will significantly expand funding capabilities for companies and ventures that are too small for traditional venture capital funding or companies that are unable to obtain such capital.

Exemption from Securities Act Registration Expanded to Include Offerings of Securities up to $50 Million

In order to facilitate the capital raising process of small companies, the JOBS Act directs the SEC to provide an expanded form of the exemption from Securities Act registration available under Regulation A. Most notably, this expanded exemption will effectively act to increase the offering size limitation of securities issued pursuant to Regulation A from $5 million to $50 million for a 12-month period. Also, securities issued pursuant to the expanded exemption will be considered federally "covered securities" (and thus not subject to certain state securities law requirements) if the securities are offered or sold on a national securities exchange or offered or sold to a qualified purchaser. This exemption will be available for equity securities, debt securities, and debt securities convertible or exchangeable to equity interests, including any guarantees of such securities. Securities issued pursuant to this exemption may be offered and sold publicly and will be freely tradeable in the secondary market.

An issuer relying on the expanded exemption will be permitted to "test the waters" and solicit interest in the proposed offering prior to filing any offering statement, on such terms and conditions as the SEC may prescribe. The issuer will be required to file audited financial statements with the SEC on an annual basis. In addition, the SEC may impose other requirements on the issuer, including a requirement to file with the SEC and distribute to prospective investors an offering statement and any related documents, including a description of the issuer's business operations, financial condition, corporate governance principles, and use of investor funds. The SEC may also require the issuer to disclose such documents and information on a periodic basis. The extent of the impact of the expanded exemption will depend on the rules to be adopted by the SEC.

Exchange Reporting Threshold Raised Significantly

The JOBS Act significantly changes the public company reporting threshold, which generally imposed Exchange Act registration and reporting requirements on issuers with total assets exceeding $10 million and a class of equity security held of record by 500 or more persons (with no distinction between accredited and non-accredited investors). Under the new threshold, an issuer will be subject to Exchange Act registration and reporting if it has total assets exceeding $10 million 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. This modification and increase in the threshold provides a private issuer with added flexibility with respect to its capital raising decisions. For banks and bank holding companies only, the threshold is 2,000 persons. The JOBS Act also provides that banks and bank holding companies may terminate the registration of a security if the number of holders of record of such security decreases to less than 1,200 persons.

Impact on Private Funds

The increased threshold may be of particular interest to sponsors of private investment funds relying on Investment Company Act Section 3(c)(7), as those funds typically limit themselves to 499 investors for practical reasons under current law. However, the increased threshold is unlikely to affect 3(c)(1) funds since such funds must limit the number of investors to 100 beneficial owners.

Additional Considerations

For purposes of determining whether a security is "held of record", the JOBS Act excludes securities held by persons who have received the securities pursuant to an employee compensation plan in transactions that were exempt from registration under the Securities Act. The JOBS Act also requires the SEC to adopt safe harbor provisions that issuers may rely on to determine whether certain holders

would qualify for this exclusion. Additionally, the SEC must establish a rule within 270 days that will exclude securities sold in exempt crowdfunding offerings, as discussed above, from the determination of record holders.

Broker-Dealer Registration Exemptions

Exemption for Certain Rule 506 Intermediaries

The JOBS Act amends Securities Act Section 4 to provide that a person participating in a Rule 506 offering shall not be subject to broker-dealer registration under the Exchange Act solely because that person (i) maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of the securities offered, or permits general solicitations and general advertisements by the issuer; (ii) co-invests in the securities being offered; or (iii) provides ancillary services with respect to the securities offered. To qualify for this exemption, a person must not (i) receive compensation in connection with the purchase or sale of the securities offered; (ii) have possession of customer funds or securities in connection with the offering; or (iii) be subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. This provision may be of particular interest to platforms that seek to facilitate Rule 506 offerings.

Exemption for Crowdfunding Portals

The JOBS Act also directs the SEC to establish a rule that would exempt a registered funding portal (commonly known as a crowdfunding platform) from the requirement to register as a broker-dealer, subject to certain conditions.

If you would like to discuss any of the issues in this Client Alert, please contact any attorney in our Corporate Finance and Securities Group or visit us online at chapman.com.