Congress Reforms Capital Access With the Jumpstart Our Business Startups (JOBS) Act

In rare acts of bi-partisanship, on March 8, 2012, the House of Representatives passed the Jumpstart Our Business Startups Act (JOBS Act), quickly followed two weeks later by Senate approval of the JOBS Act, which included amendments that were passed by the House on March 27, 2012. The JOBS Act is expected to be signed into law by President Obama in the next few days.

Background

The Congressional supporters of the JOBS Act believe that the legislation will create jobs in the United States by increasing economic growth through improved access to the capital markets.

The JOBS Act is intended to make it easier for an “emerging growth company” to engage in its initial public offering (IPO) by creating a reduced regulatory compliance gateway – an “IPO on-ramp” for companies that are about to go public. The IPO on-ramp would reduce costs and make it easier than it previously had been to not only conduct an IPO but also meet the ongoing regulatory requirements of a public company.

The JOBS Act would also facilitate smaller companies and businesses in raising capital in other private and public offerings by reducing regulatory restrictions on private offerings and raising the thresholds that trigger public company reporting for companies that have not yet conducted a public offering.

The IPO On-Ramp

The number of US-based IPOs has plummeted from an annual average of 530 during the 1990s to about 126 since 2001, with only 38 in 2008 and 61 in 2009.[1] This can be attributed, in part, to the costs associated with regulatory compliance, which can range from US$100,000 to US$1 million per year.[2] For smaller companies these costs can be financially burdensome, and they have dissuaded some companies from pursuing an IPO.

The JOBS Act, which lightens the regulatory burdens for smaller companies, is intended to ease the transition from being a private company to being a public company and, thereby, encourage IPOs by “emerging growth companies.”

What Is an Emerging Growth Company?

The JOBS Act would amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to create a new category of issuer called an “emerging growth company,” which is defined as a company that has under US$1.0 billion in revenue. Such a company would remain an emerging growth company, and be subject to the reduced regulatory and reporting requirements associated with it, until the earliest of the:

- End of the fiscal year following the fifth anniversary of its IPO;

[1] See Weild, David and Kim, Edward, *Market Structure is causing the IPO Crisis – and more* (June 2010), 3.

[2] See Protiviti, *2011 Sarbanes-Oxley Compliance Survey* (2011), 6.

- Date it becomes a "large accelerated filer" (i.e., an issuer with an excess of US$700 million in public float);
- Date it has issued more than US$1.0 billion in non-convertible debt in the previous three years; and
- Date it achieves US$1.0 billion in revenue.

Reforms to the IPO Process

The JOBS Act encourages an emerging growth company to engage in its IPO by providing a less onerous and less regulated path to consummating an IPO. The JOBS Act provides that:

- Only two years of audited financial statements (and two years of MD&A) are required in an IPO registration statement, and future filings would not need to go back any earlier;
- IPO filings with the Securities and Exchange Commission (SEC) can be made confidentially; and
- Research reports relating to emerging growth companies and research communications with investors and management will be easier in that:
  - Investment banks will be permitted to publish research during the pendency of public offering, even if they act as underwriters;
  - Research analyst conflict of interest rules related to marketing of IPOs and "three-way" communication between research, investment banking and management will not apply; and
  - There will be no post-pricing quiet period on research reports or other communications. That is, emerging growth companies and their authorized representatives will be permitted to communicate orally or in writing with Qualified Institutional Buyers and Institutional Accredited Investors to determine interest in a potential offering whether before or after the filing of a registration statement for the offering.

Reduced Ongoing Compliance Requirements

Under the JOBS Act, emerging growth companies will be subject to reduced regulatory and reporting requirements as newly public companies, which will entail:

- Being exempt from shareholder approval requirements of executive compensation until one to three years after it ceases to be an emerging growth company;
- Being subject to less burdensome executive compensation disclosures;
- Not being required to provide an auditor attestation of management's internal controls for financial reporting as would otherwise be required under Sarbanes-Oxley; and
- Being exempt from certain accounting requirements including the audit firm rotation and the supplemental information by audit firms requirements.

Facilitating Capital Raising for Smaller Companies

The JOBS Act includes a number of other provisions that expand opportunities for companies to raise capital in private and small public offerings without triggering SEC registration requirements under the Securities Act of 1933 or the Securities Exchange Act of 1934.

- ***General Solicitation Under Regulation D.*** The prohibition on general solicitation when conducting certain private placements would be removed so that companies would be allowed to broadly advertise when conducting private placements.

- ***Crowdfunding.*** Crowdfunding refers to a form of capital raising where groups of people pool money composed of small individual contributions to support accomplishment of a particular goal, such as funding a small business. Under the JOBS Act, companies would be able to raise limited amounts of capital from a large pool of small investors without registration under the securities laws. Entrepreneurs could raise up to US$1.0 million in any 12-month period (or US$2.0 million if audited financials are provided to investors) from a large pool of small investors, subject to limitations based on investor income levels. The amount of securities sold to each investor in any 12-month period would be capped at the lesser of 10 percent of that investor's annual income or US$10,000.
- ***Raised Limit Under Regulation A.*** Regulation A, which is rarely used today because of the low offering cap and the associated regulatory burdens, would be amended so that it could be a viable means for a company to conduct a mini-public offering. The limit for offerings would be raised from US$5 million to US$50 million, and Regulation A offerings would be exempt from state securities laws so long as the securities are sold through a broker-dealer or offered or sold over a national securities exchange. Issuers would still have to comply with SEC-promulgated regulations including filing of an offering memorandum containing required disclosures as well as the annual filing of audited financial statements and other periodic disclosures as the SEC determines.
- ***Shareholder Caps.*** The maximum number of shareholders of record that a private company can have before it must register with the SEC as a public company would be increased from 500 to 1,000 so long as fewer than 500 are non-accredited investors. This maximum would exclude any shareholders who received their securities pursuant to an employee compensation plan or as part of the new crowdfunding exemption. Similarly, the shareholder cap applicable to banks and bank holding companies would be raised to 2,000 without further limits on shareholders that are not accredited investors.

Potential Impacts of the Proposed Legislation

Supporters of the JOBS Act expect that the legislation, once enacted, will mean smaller companies will take advantage of the alternative capital sources afforded by the proposed legislation. Critics of the JOBS Act, including the SEC, have predicted that the scaled-back regulation will mean reduced protection for investors and the undesirable effect of reducing confidence in the economy.

The JOBS Act is expected to have the most impact on small and mid-sized emerging companies. Easier access to public markets could potentially offer significant flexibility to companies that are in the early stages of development, expansion and commercialization, particularly those without the need for large amounts of capital, such as many software companies.

Potential for Seed-Stage Battles – Competition Among Funding Sources?

Because the JOBS Act makes buying shares of companies easier for individual investors, it could conceivably lead to competition among potential funding sources, thereby making funding more competitive.

As a general matter, venture capital funds have expressed support of the proposed legislation. Traditional funding sources argue that they offer material benefits other than just capital funding such as valuable business connections, tactical and strategic advice, and partnerships with other startups in their portfolio. In addition, certain startups are likely to prefer raising funds from professional sources as professional investors are more likely to protect (and it is easier to control with a fewer number of investors) any confidential information revealed to investors prior to funding. Some think that first-round funding from JOBS Act sources will be viewed favorably by later-round investors, while resorting to JOBS Act sources after a professional investor round may be perceived to indicate a loss of confidence by the earlier-round investors.

With the JOBS Act not yet enacted, it is difficult to predict which companies may take advantage of the capital-raising options afforded in the JOBS Act; however, the general consensus among some startups, including tech startups, seems to indicate that companies seeking seed-stage capital and companies with limited capital requirements may pursue JOBS Act sources, while for others the preference may be to remain with more traditional funding sources when it comes to raising the majority of their working capital.

Reduced Investor Protection

Critics of the JOBS Act have voiced that one of the potential consequences of the new legislation will likely be an increase in the number of scams, which would correspondingly lead to a rise in small-investor lawsuits. The majority of those that protest the JOBS Act suggest that Congress seems to have forgotten why regulations such as Sarbanes-Oxley and Dodd-Frank were enacted in the first place. While it may be true that smaller companies are financially burdened by the requirements under such regulations, these are the very regulations that were enacted to protect investors and prevent downturns like the Great Recession or the dot-com crash. Critics of the JOBS Act are concerned that it exposes investors to preventable disasters, arguing that loosened regulations create instability that could ultimately harm the economy more than help it.

State and federal securities groups have made it clear that they are opposed to the new proposed legislation. One of the more vocal protestors of the JOBS Act has been SEC Chairman Mary Schapiro, who in a letter to the Senate banking committee wrote, “Too often, investors are the target of fraudulent schemes disguised as investment opportunities. As you know, if the balance is tipped to the point where investors are not confident that there are appropriate protections, investors will lose confidence in our markets and capital formation will ultimately be made more difficult and expensive.” In addition, Jack E. Herstein, president of the North American Securities Administrators Association, said in a statement, “While well intentioned, the JOBS Act . . . sacrifices essential investor protections without offering any prospects for meaningful, sustainable job growth.”

More specifically, critics are concerned that there will be an increased number of scam artists persuading unsophisticated investors to invest in fraudulent business plans, and, as a result, there will also be many more people who will have invested in companies in hopes of favorable returns only to find they have lost their entire investment. Another concern voiced by critics is that the JOBS Act raises the potential that investment bankers may be incented to urge immature companies to go public prematurely.

Since the JOBS Act has already been approved by Congress and is expected to be signed into law in the next few days, there will almost certainly be no change made to the legislation in consideration of these concerns.

If you have any questions regarding this topic, please contact one of the lawyers listed below or your regular contacts at Squire Sanders (US) LLP.

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