The Legal Intelligencer

The JOBS Act — Will It Kick Start Employment Growth?

For years, as private companies grew and sought to raise funds in the capital markets, they faced significant challenges from the constraints of the rules and regulations administered by the Securities and Exchange Commission.

KATAYUN I. JAFFARI AND JILL M. STADELMAN

2012-05-03 12:00:00 AM

For years, as private companies grew and sought to raise funds in the capital markets, they faced significant challenges from the constraints of the rules and regulations administered by the Securities and Exchange Commission.

If a company grew beyond a certain size, it would find itself subject to rules such as reporting requirements under the Securities Exchange Act of 1934 without having made the conscious decision to go public. Even raising capital proved challenging because of the many SEC rules, such as the prohibition on general solicitation when conducting a private offering. With the recession causing businesses to tighten spending and frequently causing small businesses to struggle and ultimately fail, Congress and President Obama have passed legislation with the hope of spurring business and job growth.

The Jumpstart Our Business Startups (JOBS) Act was passed by Congress on March 27 and signed into law by the president on April 5. A goal of the JOBS Act is to address some of the challenges noted above that stifle business growth. While this article addresses the potential practical effects of the JOBS Act, please see the following link for a detailed summary of the provisions of the JOBS Act:www.ballardspahr.com/alertspublications/legalalerts/2012-04-06_jobs_act_significantly_alters_federal_securities_laws.aspx.

OVERVIEW OF THE ACT

The JOBS Act is a bipartisan law designed to help companies raise capital privately, remain private longer and, for those that choose to go public, to do so more easily. The JOBS Act:

• Creates new private placement exemptions permitting crowdfunding. Under these exemptions, U.S. private companies are permitted to raise up to $1 million over a 12-month period from large pools of small investments subject to individual investment limits.

• Eliminates the prohibition on general solicitation in private placements pursuant to Rules 506 and 144A of the Securities Act of 1933 (Securities Act), provided that all purchasers of the securities are either accredited investors or qualified institutional buyers.

• Creates a new class of issuer subject to reduced public company disclosure obligations called an emerging growth company (EGC), which is a company with less than $1 billion in gross revenue during its most recently completed fiscal year.

• Increases the registration thresholds under Section 12(g) of the Exchange Act to either 2,000 holders of record or 500 persons who are not “accredited investors.”

As with any significant new legislation, the JOBS Act has its supporters and its critics. Entrepreneurs believe the JOBS Act will prove to be a lifeline to new capital and will better enable small companies to grow. Critics believe the JOBS Act may open the door to increased amounts of investor fraud, the type of fraud that prior legislation, such as the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, were designed to prevent.

PRE-JOBS ACT

Prior to the adoption of the JOBS Act, SEC rules impeded growth of private companies because growth often came with significant regulatory compliance costs. These SEC rules subjected a growing company to reporting obligations if it crossed certain thresholds, regardless of what the company’s business plan may have contemplated.

The cost of becoming a reporting company, both in terms of diversions of management’s attention and third-party fees, can be burdensome. Companies were also limited in how they could raise capital without conducting a public offering, again resulting in increased cost to the company.

Section 12(g) of the Exchange Act provided that a private company became subject to the reporting requirements if the company had total assets valued at more than $10 million and a class of equity securities held by 500 or more holders. As a reporting company, it would be required to file annual, quarterly and current reports, prepare audited financial statements and comply with the provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act. Once a company exceeded the 500-shareholder limit, it was then required to start reporting within 120 days of the last day of the fiscal year it exceeded this limit.

This rule likely impacted Facebook’s decision to prepare for its initial public offering this spring. Due in part to equity awards to its employees and trading on secondary markets, Facebook likely crossed the 500-shareholder threshold in 2011. The JOBS Act provides more flexibility to private companies by raising the 500-shareholder limit to 2,000 shareholders of record.

Section 4(2) of the Securities Act of 1933 exempts from registration “transactions by an issuer not involving any public offering” generally. Rule 502(c) under Regulation D of the Securities Act prohibited a “general solicitation” or “general advertising” when offering and selling securities in a private placement. A general solicitation or general advertisement includes “any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.”

When determining if a general solicitation occurs, the SEC looks at whether the issuer or its agent had a “pre-existing relationship” with the offeree. In this age of 24-hour news coverage, it can be challenging for a private company — especially one with a large following, such as Facebook — to satisfy the “no general solicitation” rules when conducting a private placement. In fact, in 2011, Goldman Sachs, Facebook’s investment banker, prohibited U.S. investors from participating in a private placement of Facebook’s stock after word of the offering leaked and Goldman determined that the media coverage could result in a general solicitation. On the other hand, if a company does not have a significant Rolodex of “friends” or “family,” it is difficult for a small company to raise any capital because of the “no general solicitation” rules.

ENTREPRENEURS CELEBRATE THE JOBS ACT

Because the JOBS Act removes certain obstacles to raising capital, entrepreneurs believe it can be instrumental in starting and growing new businesses. The JOBS Act will allow companies to remain private longer (a significant cost savings), reach a broader group of investors and, when companies

are ready to go public, provide for a more gradual transition into the reporting system, decreasing management's distraction from the operation of the business and saving the company third-party costs.

For very early-stage companies, the first round of capital, seed money, can make or break the company's future. Companies at this stage are often too small to attract the interest of angel investors, and founders are forced to turn to friends and family for startup funds.

The new crowdfunding rules enable these companies to engage in limited fundraising from small investors over the Internet. A company may offer and sell up to $1 million in securities over a rolling 12-month period without registration with the SEC. While the JOBS Act imposes conditions on how much individual investors may invest and how the offering must be conducted, and requires some limited disclosure to the SEC, there are no restrictions or qualifications on who can invest in a crowdfunding investment. Finally, small, growing companies can look beyond their (or their financial adviser's) Rolodex of "accredited investors." This is a significant change to the former rules, which carried far greater conditions to any offering size.

The fact that companies will be able to engage in a general solicitation when conducting a private placement under Rule 506 will likely fundamentally change how such offerings are conducted, suggesting that raising capital will become easier and occur much more quickly. Although most financial advisers are unlikely to identify and solicit investors solely by advertising or press coverage, lifting the general solicitation restrictions will remove the uncertainty that information that is inadvertently released could jeopardize the availability of an exemption under the rules. Had this prohibition been lifted a year ago, Facebook would not have had to abandon its U.S. private placement.

The costs of going public and remaining a public company are significant. One recent study puts the average cost of going public at $2.5 million, plus ongoing annual costs of $1.5 million to satisfy regulatory requirements. In addition, compensation for executive officers and board members frequently increases upon an initial public offering. Public companies also engage more professional advisers, including legal advisers, independent registered public accountants, compensation consultants and investor relation firms. The cost of complying with the Sarbanes-Oxley Act and the Dodd-Frank Act is enough to convince some companies to remain private.

The decision to go public also means that the company must be prepared to "spill the beans" on every material aspect of its business. Audited financial statements, a description of the material risks facing the company, executive compensation programs, and all material contracts and relationships must be disclosed. This disclosure is available not just to investors, but to competitors, potential acquirers, regulators and the media. While there is a mechanism to seek confidential treatment on certain information, the disclosure of which could result in competitive harm, the SEC rules on such treatment are limited.

By raising the shareholder limit in Section 12(g) from 500 to 2,000 shareholders, the JOBS Act will allow growing private companies to maintain more control over the decision of when to go public. The JOBS Act also clarifies that persons who received securities pursuant to an employee compensation plan in transactions exempt from registration requirements are not considered recordholders. This is an important factor because, for many growing companies, equity can be a significant piece of a compensation program. A company with a larger workforce that has a practice of awarding equity could have found itself up against the 500-recordholder threshold, and thus entering the reporting system, much sooner than its business plan would have otherwise contemplated.

The JOBS Act, however, now makes it easier and less expensive for a select group of companies to go public. The "IPO on-ramp" rules applicable to emerging growth companies will allow such companies to go public without having to comply with all of the disclosure and financial reporting

requirements applicable to most public companies. Until the earlier of five years after its IPO or such time that its annual gross revenues exceed $1 billion, an EGC is subject to reduced disclosure obligations, reduced financial disclosure requirements, delayed adoption of new or revised financial accounting standards, an exemption from attestation requirements for auditors under the Sarbanes-Oxley Act, and an exemption from say-on-pay shareholder advisory votes under the Dodd-Frank Act. All of these rules will alleviate pressures on such companies and assist them in cost-savings measures. This flexibility and ability to contain costs may be a sufficient incentive to encourage some companies to go public.

A company that qualifies as an EGC can also "test the waters" prior to filing a registration statement. This would allow the company to meet with "accredited investors" and "qualified institutional buyers" and discuss the company to determine whether there would be sufficient interest in an IPO before starting the registration process. Once an EGC has decided to go public, it can submit its draft registration statement confidentially to the SEC for review. This would allow the EGC to work through disclosure issues with the SEC without alerting the public, and, if the company decides to abandon the IPO for some reason, the market will not be aware that the company ever contemplated an IPO.

CRITICS FEAR IMPLICATIONS

Critics of the JOBS Act fear that loosening the regulatory constraints may lead to investor fraud and that the JOBS Act unravels many of the protections created by the Sarbanes-Oxley and Dodd-Frank acts. Mary Schapiro, chair of the SEC, has said: "Too often, investors are the target of fraudulent schemes disguised as investment opportunities. ... 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."

Crowdfunding is an area of concern for some. While there are limits on the amounts that investors may invest in a crowdfunding offering, thus setting a ceiling for their losses with respect to a particular transaction, investors do not need to meet any specific qualifications to participate. Although issuers are required to provide some limited information, there is a concern that the investors that participate in crowdfunding offerings may not have the sophistication, or the access, to do the due diligence necessary to fully understand the investment. Some critics of the crowdfunding provisions question whether the safeguards that Congress implemented to protect investors against fraud detract too much from the usefulness of the law. All transactions must be conducted through an intermediary, either a broker or a funding portal, that meets a lengthy list of requirements regarding disclosure and mitigation of risk. If a company seeks to raise more than $500,000, it must provide audited financial statements. For many early-stage companies, the expense of using a broker or intermediary and having an audit may be too great to make a crowdfunding offering worthwhile.

Eliot Spitzer, former New York attorney general, has also been an outspoken critic of the JOBS Act, calling it a "bad sequel to a bad movie." In 2003, Spitzer helped negotiate a settlement that prohibited analysts from going public with their research, which was deemed a conflict of interest, given that analysts were hired by banks that would benefit from having shares in an IPO sell for a high price. After the dot-com bubble had burst, many investors were wary of IPOs because of these research scandals.

One provision of the JOBS Act removes restrictions regarding who within a broker-dealer can arrange communications between analysts and investors in connection with an IPO for an EGC. It also allows participation by an analyst in communications with the EGC's management where investment bankers are also present. Some view these provisions of the JOBS Act as a disregard to the lessons learned from the dot-com bubble and the victims of those scandals. It is unclear exactly what impact these provisions will have on the 2003 Spitzer settlement.

Critics have also questioned the exemptions available to EGCs. For up to five years post-IPO, an EGC is not required to have an auditor attestation of internal controls. The attestation was an integral part of the Sarbanes-Oxley Act and was intended to help prevent Enron-type scandals. This exemption may save EGCs significant amounts of money and enable management to focus on the business, but some critics fear it may also open the door to fraudulent activity. Without an independent audit of internal controls, some fear that the risk of management's failure to identify and remedy a material weakness could increase.

WHAT DOES THE FUTURE HOLD?

While the JOBS Act may not change the potential for fraud, its purpose to promote growth and spur investment can be met through its provisions. Companies that want to pull the wool over investors' eyes will continue to try to do so no matter what laws are in place. However, companies that recognize that full disclosure and transparent reviews of their financial reporting controls are likely to attract quality investors will continue to see the benefits of providing complete and accurate information to their investors and can do so with the support of their advisers.

Katayun I. Jaffari *is a partner in Ballard Spahr's business and finance department and a member of the securities, life sciences/technology, energy and project finance, and mergers and acquisitions/private equity practice groups. She can be reached at jaffarik@ballardspahr.com or 215-864-8475.*

J**ill M. Stadelman** *is an associate in the firm's business and finance department and a member of the securities, mergers and acquisitions/private equity, and life sciences/technology practice groups. She can be reached at stadelmanj@ballardspahr.com or 215-864-8504.*

Joseph W. La Barge, *of counsel in Ballard Spahr's business and finance department, assisted in the preparation of this article.*

Reprinted with permission from the May 3, 2012 issue of The Legal Intelligencer.© 2012 ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved.