PRYOR CASHMAN LLP

LEGAL UPDATE

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JOBS ACT SEEKS TO FACILITATE ACCESS TO U.S. CAPITAL MARKETS

On March 27, 2012, the U.S. House of Representatives voted to approve the Jumpstart Our Business Startups Act (the "JOBS Act"). The Senate had previously approved the JOBS Act, and President Obama is expected to sign it into law within the next few days. The JOBS Act encompasses a series of initiatives that emerged in Congress over the past year, and that were ultimately brought together in a single piece of legislation. The intention of the JOBS Act is to stimulate job growth and promote capital formation by removing and/or reducing certain costs and regulatory burdens applicable to smaller companies.

The JOBS Act seeks to achieve its purpose by adding or expanding certain private offering exemptions, by relaxing restrictions on the initial public offering ("IPO") process for certain smaller companies, by eliminating or simplifying certain disclosures required to be made by smaller companies in registration statements and periodic reports, and by allowing smaller companies to remain private for a longer period of time.

Many of the provisions of the JOBS Act – such as those relating to the IPO "on-ramp" created by Title I and the increased limit on the number of record holders that an issuer may have before it must register under the Securities Exchange Act of 1934 (the "Exchange Act") – take effect immediately. Others will require further rulemaking by the Securities and Exchange Commission (the "SEC").

This Legal Update provides an overview of the important changes to the securities laws to be effectuated by the JOBS Act and discusses the impact that the new legislation will have on different categories of market participants.

IPO "ON-RAMP" FOR EMERGING GROWTH COMPANIES

Emerging Growth Companies

Title I of the JOBS Act is designed to facilitate the IPO process for, and to reduce the regulatory requirements and related costs applicable to, a new category of issuers known as "emerging growth companies". An "emerging growth company" is defined as a company with total annual gross revenues of less than $1 billion (indexed for inflation) during its most recent fiscal year. An issuer will retain its status as an emerging growth company until the earliest of:

- the last day of the first fiscal year in which the issuer's annual revenue exceeds $1 billion (indexed for inflation);
- the last day of the fiscal year following the fifth anniversary of the issuer's first sale of common equity pursuant to an effective registration statement;
- the date when such issuer has issued more than $1 billion in non-convertible debt over the previous three-year period; and
- the date on which such issuer is deemed to be a "large accelerated filer" (generally, a company with a public float of at least $700 million that has been publicly reporting for at least one year).

An issuer that sold common equity securities under an effective registration statement on or before December 8, 2011 will not be eligible to be an emerging growth company.

The IPO Process; Permitted Activities and Communications

As part of the IPO "on-ramp" created by Title I of the JOBS Act, an emerging growth company will be permitted to submit a draft of its IPO registration statement for SEC review on a confidential basis. However, any such initial confidential submission and all amendments thereto must be publicly filed with the SEC at least 21 days prior to the roadshow for the applicable public offering. The confidential submission begins the SEC review process without publicly revealing sensitive commercial and financial information to competitors. Previously only foreign private issuers could take advantage of this confidential submission process.

The IPO registration statement will have to include only two years of audited financial statements and related MD&A disclosures, rather than up to three years as currently required. Emerging growth companies will also be permitted to communicate with qualified institutional buyers and institutional accredited investors, either prior to or following the filing date of the IPO registration statement, to gauge their interest in participating in the contemplated securities offering, without violating any "gun-jumping" restrictions.

In addition, broker-dealers – including those participating in the offering – will be able to publish or distribute research reports about an emerging growth company notwithstanding a pending IPO or other offering of the equity securities of such company. Moreover, research analysts will be allowed to participate in meetings with an emerging growth company together with investment banking staff, and following the IPO such persons will be able to publish research reports or make public appearances with respect to the securities of an emerging growth company.

Disclosure Requirements

Emerging growth companies will be subject to relaxed disclosure obligations in connection with both their IPO registration statement, and the registration statements and reports that they subsequently must file under the Securities Act of 1933, as amended (the "Securities Act"), and the Exchange Act, as applicable. Specifically, an emerging growth company:

- need not include "selected financial data" for any period prior to the earliest audited period presented in its IPO registration statement (rather than up to five years);
- may elect to comply with the less-cumbersome executive compensation disclosures applicable to "smaller reporting companies", in which case a Compensation Discussion and Analysis, among other items, would not be required;
- will not be subject to the requirement to hold non-binding stockholder votes on executive compensation arrangements, including "golden parachute" provisions;
- need not provide an auditor attestation report on its internal controls assessment under Section 404(b) of the Sarbanes-Oxley Act (although the CEO and CFO will still be responsible for establishing and maintaining internal controls over financial reporting and certifying to those internal controls in periodic filings);
- will be exempt from the pending requirement to disclose the relationship between executive compensation actually paid and the financial performance of the issuer;
- will be exempt from the pending requirement to disclose the ratio of CEO-compensation to the median compensation of all employees; and
- need not comply with any new or revised financial accounting standard until private companies are also required to comply with that standard.

The JOBS Act also exempts emerging growth companies from any rules promulgated by the Public Company Accounting Oversight Board requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor provides additional information about the audit and the financial statements of the issuer.

An emerging growth company may forgo reliance on any exemption available to it. However, it if chooses to comply with financial reporting requirements applicable to non-emerging growth companies, the emerging growth company must comply with all such standards and cannot selectively opt in or opt out of requirements. Any

election must be made at the time the emerging growth company files its first registration statement or Exchange Act report.

Elimination of "General Solicitation" Restrictions on Rule 506 Offerings

Title II of the JOBS Act relaxes one requirement that has limited use of the most popular exemption used for domestic private placements, namely, Rule 506 under Regulation D. A primary reason for its popularity is that, under Rule 506, the amount that can be raised is virtually unlimited and, so long as the offering is made only to "accredited investors" (as defined in Rule 501(a) of Regulation D), the number of investors is likewise (at least theoretically) unlimited.

However, issuers relying on Rule 506 have been prohibited by Rule 502(c) from engaging in any form of "general solicitation or advertising" to attract investors. The SEC has never precisely specified what constitutes a "general solicitation," although a number of no-action letter have set out guidance on the "manner of offering" restrictions of Rule 502(c). Issuers have often been cautioned that to avoid a general solicitation an issuer must approach only offerees with whom the issuer has a "pre-existing substantive relationship."[1] Over the last several years, many commentators have noted the deleterious effects on issuer's capital raising created both by this "general solicitation" limitation and by the vagueness and apparent internal contradiction in its interpretation.

Title II of the JOBS Act amends Section 4 of the Securities Act to state specifically that a Rule 506 private placement shall not be deemed a public offering solely as a result of general solicitation or general advertising. It also orders the SEC to modify Rule 506 within 90 days of enactment of the statute to provide that the prohibition against general solicitation or general advertising does not apply to Rule 506 offerings, provided that all purchasers of the securities are accredited investors.[2]

There is one caveat in the new law, however. The statute mandates that the SEC specify methods constituting "reasonable steps" that the issuer must take to verify that the purchasers are accredited investors. Although the specific methods for verification will not be known for at least 90 days, the required rulemaking presumably means that an issuer will not be able to rely on an unsupported representation by the purchaser that the purchaser is an accredited investor.

The changes to the law leave unanswered what methods or content the SEC will permit (or require) to be used in connection with a "general solicitation" and how activities conducted in connection with general solicitations may affect other fundraising efforts by issuers, particularly if non-accredited investors are exposed to the content of the solicitation. As one possible example, the SEC could take the view that the materials used in the general solicitation constitute materials designed to arouse public interest in the issuer (i.e., "gun jumping") and thus require delay of a subsequent public offering, particularly if there were any reference in the general solicitation materials to the proposed public offering.

Angel Networks

Title II also seeks to remove any uncertainty regarding the role that investor forums have played in bringing start-up companies and accredited investors together. With respect to securities offered in compliance with Rule 506, it exempts from the requirements to register as a broker or dealer anyone who either (1) maintains a "platform" (whether online, in person or through any other means) for making general solicitations, exchanging information or negotiating with respect to such securities, (2) co-invests in such securities or (3) provides "ancillary services" with respect to such securities. Title II defines "ancillary services" as (1) providing due diligence services (so long as the services do not include investment advice or recommendations to issuers or investors for

[1] See, e.g., Bateman, Eichler, Hill Richards, Inc. (pub. avail. Dec. 3, 1985); Lamp Technologies (pub. avail. May 29, 1997).

[2] A parallel provision allows for general solicitation in a Rule 144A offering, provided the offered securities are ultimately purchased by qualified institutional buyers.

separate compensation) and (2) providing standardized documents (so long as the platform operator and associates do not negotiate the terms of the issuance for or on behalf of third parties and so long as issuers are not required to use those forms as a condition of participating in the platform).

However, the exemption can only be claimed if the person maintaining the platform and each individual associated with that person (A) receives "no compensation in connection with the purchase or sale of such security", (B) does not take possession of customer funds or securities in connection with sales of such securities and (C) does not fall into one of the statutory disqualification (i.e., "bad actor") categories of Section 3(a)(39) of the Exchange Act.

While in general these changes seem beneficial to platform operators, one concern is the prohibition on any compensation being received by a platform operator "in connection with" the purchase or sale of such securities. This wording seems to go beyond what was contemplated in the version of Title II that originated in the House of Representatives. House Report 112-263 states that "the SEC should only treat these forums as broker-dealers if they receive *transaction-based fees* for their activities." (Emphasis added.) It remains to be seen if SEC rulemaking will preserve the distinction between the House Report's "transaction-based" fees and the final statute's "no compensation".

CROWDFUNDING

Title III of the JOBS Act responds to a growing belief among many politicians and business people that entrepreneurs should be able to use the Internet to raise money by aggregating small amounts of cash from numerous individuals. President Obama mobilized substantial fundraising contributions from small donors using the Internet during his 2008 campaign. Websites such as Kickstarter have promoted various art and other charitable projects by raising small donations from many people. Thus, in the view of some, companies should be able to do the same with small investors.

Title III of the JOBS Act adds a new Section 4(6) "crowdfunding" exempt offering to the Securities Act. The exemption is available if the aggregate amount of all securities sold to investors by the issuer and its affiliates during the 12-month period prior to the latest transaction (including but not limited to the crowdfunding securities) does not exceed $1,000,000.

Ordinarily, the offer of securities to large numbers of investors would require registration in the absence of an available exemption. From an investor protection point of view, registration is particularly appropriate where, as with "crowdfunding", it is likely that some or all of the purchasers are likely to be non-accredited investors. Therefore, Title III seeks to balance the desire to make crowdfunding technology available to entrepreneurs with the desire to preserve some protections for these non-accredited investors.

As a result, an issuer seeking to rely on the crowdfunding exemption adopted by Title III cannot simply post its offering on a website and accept offered cash. The provisions impose a significant number of requirements on the manner of offering the securities and the types of information that must be made available to investors, the SEC and state regulators, as well as requirements for updating the information during the offering and after the offering is completed.

Perhaps most significantly, new Section 4A of the Securities Act requires that any "crowdfunding" offer be conducted through a broker or "funding portal", not directly by the issuer itself.[3] The broker is required to do the following:

[3] A funding portal is defined by a new Section 3(a)(80) of the Exchange Act as an intermediary involved specifically in the offer or sale of securities pursuant to Section 4(6) that does not (1) offer investment advice, (2) engage in solicitation of transactions in the offered securities, (3) compensate anyone for such solicitations or on the basis of sales of such securities, (4) handle investor funds or securities or (5) engage in any other activities that the SEC deems inappropriate. A funding portal is to be exempt from registration as a broker or dealer, but will nevertheless have to register with the SEC as well as with "any applicable self-regulatory organization". It remains, however, subject to the examination, enforcement and other rulemaking activity of the SEC and such other requirements of the Exchange Act as the SEC deems appropriate and it must be a member of a national securities association registered under Section 15A of the Exchange Act (although the

- provide various disclosures, including disclosures relating to risks, and other investor education materials (to be prescribed by SEC rule);
- ensure that each investor (a) reviews these disclosures and materials (in accordance with standards to be established by the SEC), (b) affirms that the investor understands the risk of potential loss of the entire investment and that the investor can bear the loss and (c) answers questions demonstrating that the investor understands the risks of start-up investing, illiquidity of the investment and "such other matters as the SEC determines by rule";
- take measures (to be established by the SEC) to reduce the risk of fraud, including obtaining a background check and securities enforcement history on each officer and director of the issuer and person holding more than 20 percent of the issuer's securities;
- make certain information required to be provided by the issuer (see below) available to the SEC and to potential investors at least 21 days prior to the first sale of securities;
- ensure that proceeds are only released to the issuer after a target offering amount is reached and allow for investors to cancel their commitments (as determined by SEC rule);
- verify (to the extent deemed necessary by the SEC) that no investor has exceeded the limits on aggregate investment in the issuer required by the exemption (see below);
- protect the privacy of information collected from investors (to the extent determined by SEC rule);
- not compensate any finder, promoter or others for providing "personal identifying information" of any potential investor;
- prohibit its own directors, officers or partners from having any financial interest in the issuer; and
- meet such other requirements as the SEC may deem appropriate for the protection of investors.

national securities association can only enforce rules adopted specifically for such portals).

The provisions of new Section 4A also subject the issuer using the exemption to an additional set of detailed requirements. The issuer must:

- file extensive disclosure with the SEC and provide to the investors and the relevant broker or funding portal information regarding (1) the name, address and website address of the issuer; (2) the names of its directors and officers and each person holding more than 20 percent of its shares; (3) its business and its anticipated business plan; (4) its financial condition[4]; (5) the stated purpose and intended use of the proceeds of the offering; (6) the target offering amount, the deadline to reach the target amount and "regular updates" on the progress of the offering; (7) the price (or the method for determining the price) of the securities offered and a reasonable opportunity to rescind the purchase commitment if the final price is not determined at the time the commitment is made; (8) a description of the ownership and capital structure of the issuer and the terms of the offered securities (including how the offered securities have been valued and the risks of being a minority owner); and (9) such other information as the SEC may require;
- not advertise the terms of the offering, other than to direct investors to the funding portal or broker;
- not compensate anyone to promote the offering unless the person clearly discloses the receipt of compensation in connection with any such promotional communication (pursuant to rules to be adopted by the SEC);

[4] Specifically, issuers using the exemption must provide the following financial information, depending upon the size of the offering: (a) income tax returns and financial statements certified as true and complete by the principal executive officer (if the aggregate offering amounts within the previous 12 months is $100,000 or less), (b) financial statements reviewed by an independent public accountant (if the aggregate offering amounts are between $100,000 and $500,000) or (c) audited financial statements (if the aggregate offering amounts are more than $500,000 (or such other amount as the SEC may establish)).

- file at least annually with the SEC (and provide to investors) reports of the results of operations and financial statements (as specified by SEC rule); and
- comply with such other requirements as the SEC may prescribe.

The information required to be made available by the issuer as described above is also to be made available to any state securities agency. However, securities issued under a Section 4(6) exemption are deemed "covered securities" under Section 18(b)(4) of the Securities Act and therefore will be exempt from certain state "blue sky" requirements except that notice filings may be required in the state where the principal place of business is located or where purchasers of 50 percent or more of the offering are residents. Also, the rights of state authorities to take enforcement actions against the issuer, any broker or funding portal are preserved.

The exemption restricts the aggregate amount that may be sold to any investor by the issuer during the 12-month period prior to the latest transaction to either $2,000 or five percent of the investor's annual income or net worth (if either the annual income or net worth is less than $100,000) or ten percent of the investor's annual income or net worth (if either the annual income or net worth is more than $100,000), provided that in the latter case, the maximum aggregate amount that can be sold to the investor during the 12-month period is $100,000. Like the overall limitation on the aggregate amount of securities that can be offered in the 12 months prior to the offering date, the caps expressed in the limitations on individual investors include not only securities sold pursuant to the crowdfunding exemption during those 12 months but also any other securities of the issuer purchased by that investor without regard to the 12-month period. As noted above, it is the responsibility of the broker or funding portal to verify that each investor is in compliance with these limits.

Issuers remain liable for material misstatements and omissions in information provided in a crowdfunding offer.[5] Securities purchased in a Section 4(6) transaction may not be transferred by the purchaser for one year following the date of purchase except to the issuer, to an accredited investor, as part of a resale registration statement filed with the SEC, to a "member of the family of the purchaser or the equivalent" or, in the discretion of the SEC, in connection with the death or divorce or other similar circumstance affecting the purchaser.

Finally, consistent with the amendments to Section 12(g) of the Exchange Act discussed below, purchasers who acquire securities in a crowdfunding transaction will not be included in calculating the maximum number of record holders that an issuer may have before it must register under the Exchange Act.

Increased Ownership Threshold for Exchange Act Reporting

Section 12(g) of the Exchange Act, together with related rules, currently requires that an issuer register a class of equity securities with the SEC if, on the last day of the issuer's fiscal year, such class of securities is held of record by 500 or more persons and the issuer has assets of more than $10 million. Registration of a class of equity securities subjects an issuer to the periodic reporting requirements of Section 13, the proxy requirements of Section 14, and the insider reporting and short swing profit provisions of Section 16 of the Exchange Act.

Title V of the JOBS Act amends Section 12(g) of the Exchange Act to dramatically increase the number of record holders that a company can have before it is obligated to register under the Exchange Act. Specifically, an issuer (other than a bank or bank holding company) does not have to register with the SEC until such time as it has total assets exceeding $10 million and a class of equity securities that is held of record either by 2,000 persons or by 500 persons who are not accredited investors. For an issuer that is a bank or bank holding company, Title VI of the JOBS Act amends Section 12(g) of the Exchange Act so that such an issuer does not have to register with the SEC until such time as it has total assets exceeding $10

[5] For purposes of the exemption, the term "issuer" is deemed to include any person who is a director or partner of the issuer and the principal executive officer or officers, principal financial officer and controller or principal accounting officer of the issuer and any person who offers or sells the security in a Section 4(6) offering.

million and a class of equity securities held of record by 2,000 or more persons, regardless of whether such holders are accredited. The measurement date for determining whether the asset and record holder thresholds have been met is the last day of the issuer's fiscal year. These changes are effective immediately upon enactment.

Securities held by persons who received them pursuant to employee compensation plans exempt from Section 5 of the Securities Act, or sold in exempt "crowdfunding" transactions, will not be considered "held of record." Although most companies will still not be able to deregister until they have fewer than 300 holders of record, the new legislation permits banks and bank holding companies to deregister once they have fewer than 1,200 holders of record.

The significant increase in the threshold for record holders, combined with the new exemptions regarding what securities are deemed to be "held of record," will make it much easier for private companies to avoid becoming subject to the requirements of the Exchange Act. This will be particularly helpful for emerging companies that have relied upon the use of stock-based compensation to incentivize their employees, and have had to balance such issuances with a desire to maintain a limited number of record holders.

The increased limits under Section 12(g) may also provide benefits for private investment funds, including hedge funds and private equity funds, that seek to avoid registration as an "investment company" [6] and other regulations by relying on the exclusion from the definition of "investment company" afforded by Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "ICA"). Although technically permitted to have an unlimited number of "qualified purchasers"[7] as a private fund, from a practical standpoint such funds were prevented from having more than 499 record holders if they wished to avoid having to register under the Exchange Act. By significantly increasing the threshold for record holders, the JOBS Act will potentially permit such funds to sustain a more diversified investor base, without becoming subject to the requirements of the Exchange Act.

As a result of the amendments to Section 12(g), private companies should review and, if necessary, update their internal record keeping functions to ensure that they maintain an accurate record of those issuances that will and will not count against the record holder limits.

Increased Cap for Regulation A Offerings

Regulation A currently provides an exemption from registration under Section 3(b) of the Securities Act for offerings by U.S. and Canadian non-reporting companies of up to $5 million per 12-month period that meet the criteria set forth in Regulation A. This exemption is rarely used due to the low offering cap, the need to comply with state "blue sky" laws, and the popularity of more desirable offering exemptions, including Regulation D.

Title IV of the JOBS Act requires the SEC to amend the Regulation A offering exemption to remove certain of the limitations on capital raising transactions contained therein. The most significant changes to the exemption would be to:

- substantially increase the offering cap so as to exempt from registration offerings of up to $50 million of securities (i.e., equity securities, debt securities, and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities) per 12-month period; and
- provide that securities offered or sold under the exemption will be exempt from state securities regulation, but only if such securities are either (i) offered or sold on a national securities exchange or (ii) offered

[6] For further information on the provisions of the JOBS Act that impact private investment funds, please see the Pryor Cashman Legal Update entitled "JOBS Act Lifts the General Solicitation Prohibition and Increases the Record Holder Threshold for Private Investment Funds" (April 2012).

[7] In general, a "qualified purchaser" is defined under Section 2(a)(51)(A) of the ICA, and related rules, to be a person that the issuing private investment fund reasonably believes is a natural person who owns not less than $5 million in investments or a non-natural person that owns and invests on a discretionary basis not less than $25 million in investments. The SEC has defined the term "investments" for this purpose in Rule 2a51-1 under the ICA.

or sold to “qualified purchasers”, as defined under the Securities Act for this purpose.

Issuers that take advantage of Regulation A, as amended, will be required to file audited financial statements with the SEC annually. The SEC may also impose other terms, conditions or requirements deemed necessary for investor protection, including a requirement that the issuer prepare and electronically file with the SEC an offering statement that includes audited financial statements, a description of the issuer’s business and financial condition, its corporate governance principles, its use of investor funds, and other appropriate matters, as well as periodic disclosures that contain substantially the same types of information. The SEC may promulgate “bad actor” disqualification provisions, similar to those contained in Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, under which the exemption will not be available. There is no timetable for the SEC to adopt final rules to implement the modifications to Regulation A.

Every two years following the date of enactment, the SEC must review the $50 million offering amount limitation and increase it as the SEC deems appropriate. The SEC must also conduct a study on the impact of state “blue sky” laws on offerings made under Regulation A, and report to Congress on the results of this study not later than three months after the enactment of the JOBS Act. There are many perceived negatives of Regulation A offerings that the JOBS Act does not address in any significant way. As a result, it is unclear whether Regulation A offerings will become more widely used as a result of the amendments and the adoption of final rules by the SEC. In particular, since the statutory changes only provide that Regulation A securities will be considered “covered securities” under Section 18 of the Securities Act if they are exchange-listed or are offered and sold only to “qualified purchasers”, in many instances (unlike Rule 506 securities) issuers will still have to qualify Regulation A securities under state “blue sky” laws. It remains to be seen whether the SEC’s report on the relationship of state “blue sky” laws and Regulation A results in Regulation A securities being included more broadly in the definition of “covered securities”.

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The foregoing is merely a discussion of the JOBS Act. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen Goodman at 212-326-0146 or Michael Campoli 212-326-0468.

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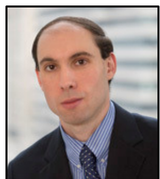
Mr. Goodman has also written on topics ranging from raising seed capital for entrepreneurial companies to the SEC's whistleblower rules to the Supreme Court's decision regarding material nondisclosure in *Matrixx Initiatives, Inc. v. Siracusano*, and has lectured on various aspects of capital formation at Columbia University, the City University of New York and the New York Academy of Sciences. His most recent article is "Still Room for Finders? Courts Question SEC View of Broker Activity" (*BNA Securities Regulation & Law Report*, November 14, 2011).

Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.



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Michael Campoli devotes his practice to counseling public and private companies on a broad range of corporate matters, including compliance with federal and state securities laws, reporting under the Securities Exchange Act, corporate formation and governance, mergers and acquisitions, public and private equity and debt financing transactions, and limited liability company and partnership counseling.

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- Javelin Pharmaceuticals, Inc. (NYSE Amex: JAV) as outside general counsel in connection with its equity financings and Exchange Act reporting requirements
- Henry Schein, Inc. (NASDAQ: HSIC) in connection with the acquisition of various private companies in the medical device and software industries
- Cowen and Company, LLC, Rodman & Renshaw, LLC and Global Hunter Securities, LLC in connection with various underwritten public offerings for domestic and foreign issuers
- Briad Restaurant Group in its prevailing tender offer for Main Street Restaurant Group, Inc., the largest T.G.I. Friday's franchisee
- The Kushner Companies in connection with its acquisition of the office building located at 666 Fifth Avenue, New York, New York
- A private telecommunications company in connection with the issuance of secured notes to the Rural Utilities Service of the U.S. Department of Agriculture and the concurrent placement of preferred stock to venture capital investors