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The JOBS Act: Reforms to the Capital Raising Process (Updated)

May 8, 2012

On April 5, 2012, President Barack Obama signed into law the "Jumpstart Our Business Startups Act" (the "Act"). The Act significantly eases restrictions under the Securities Act of 1933 (the "Securities Act") relating to the initial public offering ("IPO") process for equity securities of a newly designated class of smaller companies and to the private placement capital raising process for virtually all issuers. The Act also provides ongoing relief, mainly for these smaller companies, from certain requirements under the Securities Exchange Act of 1934 (the "Exchange Act") as well as from certain existing (and potentially future) accounting and auditing rules. This memorandum is an updated version of our memoranda dated April 2, 2012 and April 27, 2012. It has been updated to reflect guidance issued by the Division of Corporation Finance (the "Division") of the Securities and Exchange Commission (the "SEC") prior to the date hereof.

As discussed in greater detail below, the Act

- Grants any "emerging growth company" (an entity that issues or proposes to issue any security and that has less than $1 billion in total annual gross revenues) relief from, among other things, certain financial disclosures required in its common equity IPO registration statement; allows an emerging growth company to elect confidential review of its common equity IPO registration statement by the SEC; and provides relief for up to five years from certain proxy statement requirements, auditor attestation requirements with respect to internal control over financial reporting ("ICFR") under section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") and certain other existing and potential accounting and auditing rules.

- Eases restrictions on pre- and post-offering research activities by investment banks and permits emerging growth companies and investment banks to "test the waters" with specified investors prior to or following the filing of an emerging growth company's registration statement.

- Directs the SEC to eliminate the prohibition on general solicitation in connection with Rule 144A offerings and private placements under Rule 506 of Regulation D under the Securities Act so long as sales are made only to eligible investors.

- Directs the SEC to add a new exemption from registration for up to $50 million of securities (up from $5 million under current Regulation A) and creates an exemption for "crowdfunding" by small investors through brokers and "funding portals".

- Raises the thresholds for determining when private companies must register under section 12(g) of the Exchange Act and thereby become subject to the Exchange Act's reporting obligations.

Many provisions of the Act became effective immediately upon signing, including much of the relief relating to the IPO process for emerging growth companies. However, the SEC must adopt rules to implement other changes and needs to provide guidance on how it will implement some of the otherwise self-executing changes. The Division has issued guidance on some of these changes in the form of answers to frequently asked questions and is expected to issue additional guidance.[1] The Act prescribes specified time periods for the adoption of certain of these rules and also requires the SEC to undertake various studies

[1] Links to the Division's FAQs related to the Act can be found at http://www.sec.gov/divisions/corpfin/cfjobsact.shtml.

and recommend additional rule changes within certain time frames. We do not anticipate that the SEC will be able to meet all of the specified target dates. SEC Chairman Mary Schapiro has already publicly stated that the Act "requires a series of new, significant Commission rulemakings with time limits that are not achievable."

SPECIAL TREATMENT FOR "EMERGING GROWTH COMPANIES" CONDUCTING IPOS

The Act creates a new category of issuers, called "emerging growth companies", which are companies that had total annual gross revenues[2] of less than $1 billion during the most recently completed fiscal year (indexed for inflation every five years) that complete their first registered sale of common equity securities after December 8, 2011. An emerging growth company will retain this status until the earliest of (1) the last day of the fiscal year during which the company had total annual gross revenues of $1 billion or more (adjusted for inflation as mentioned above), (2) the last day of the fiscal year following the fifth anniversary of the company's first registered sale of common equity, (3) the date on which the company has, during the prior three-year period, issued more than $1 billion of non-convertible debt[3] and (4) the date on which the company is deemed to be a large accelerated filer under the Exchange Act.[4] According to guidance from the Division, a successor entity will not qualify as an emerging growth company if its predecessor had its first registered sale of common equity on or before December 8, 2011. Furthermore, neither asset-backed securities ("ABS") issuers subject to the requirements of Regulation AB nor investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act") may qualify as emerging growth companies. However, business development companies[5] may qualify.

With few exceptions, the Act does not provide for a grace period for an emerging growth company to phase in compliance with standards applicable to issuers generally once it no longer qualifies as an emerging growth company. This could pose a challenge for an emerging growth company that unexpectedly meets or surpasses the $1 billion revenue threshold toward the end of any fiscal year. For example, a SOX 404(b) ICFR audit (discussed below) typically takes months of preparation, and would be nearly impossible to accomplish if an emerging growth company were unexpectedly to become aware in its fourth fiscal quarter that such an audit would be required for the current fiscal year and had not previously engaged its auditors to begin the ICFR audit process.

Emerging growth companies also have the option of foregoing any of the exemptions provided by the Act. Furthermore, it appears that with the exception of the delayed implementation of accounting standards discussed below, emerging growth companies may periodically make new determinations as to which exemptions they choose to use.

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[2] According to guidance issued by the Division, "total annual gross revenues" means "total revenues as presented on the income statement presentation" whether under U.S. generally accepted accounting principles ("U.S. GAAP") or International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") (for foreign private issuers). When determining total annual gross revenues, financial institutions should use the same test as they would when determining smaller reporting company status, *i.e.*, they should count all gross revenues derived from traditional banking activities, but not count gains and losses on dispositions of investment portfolio securities.

[3] According to guidance issued by the Division, "non-convertible debt" means any non-convertible security that constitutes indebtedness, whether issued in a registered offering or not. The test is based on aggregate debt issued during the three-year period (including refinancings, such as roll-overs of commercial paper), not on debt outstanding. However, the Division has stated that it will not view debt issued in a so-called A/B exchange offer (whereby an issuer undertakes a registered offer to exchange a series of unregistered notes sold in a private offering for a new series of registered notes having terms substantially identical to those of the original notes) as new debt when determining emerging growth company status; rather, it will view the exchange offer as the completion of a single financing that began with original unregistered debt issuance.

[4] A company will be deemed to be a "large accelerated filer" after it meets the following conditions as of the end of its fiscal year: (1) having an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter, (2) having been subject to the requirements of section 13(a) or 15(d) of the Exchange Act for at least 12 calendar months, (3) having filed at least one annual report pursuant to section 13(a) or 15(d) of the Exchange Act, and (4) not being eligible to use the requirements under the Exchange Act for "smaller reporting companies" for its annual and quarterly reports.

[5] "Business development companies" are closed-end companies that invest in portfolio companies, in many cases startups, and that make available significant managerial experience to such portfolio companies. They are not required to register as investment companies under the Investment Company Act, but are subject to certain of its provisions.

Emerging growth companies are granted the following relief in connection with their IPOs:

- **Confidential submission of draft IPO registration statements**. Prior to the date of the first sale of its common equity securities under an effective registration statement,[6] an emerging growth company may confidentially submit a draft registration statement[7] to the SEC, provided that the initial confidential submission and all amendments thereto are publicly filed at least 21 days before the commencement of a road show related to the offering under the registration statement.[8] Unlike the confidential submission procedures that were in place for all foreign private issuers prior to December 8, 2011 (and remain in place in a more limited set of circumstances), the Act requires "the initial confidential submission and all amendments" to be publicly filed. The Division has confirmed that, consistent with current practice, SEC staff comment letters and the issuer's responses will not be made public by the SEC until at least 20 business days after the effective date of the registration statement.[9] When an issuer is required to file the confidential submissions, such submissions must be filed as exhibits to the first registration statement filed on EDGAR. Confidential review is not available for Exchange Act-only registration statements, *e.g.*, Form 10 and Form 20-F. Furthermore, submission of a draft registration statement for confidential review does not constitute a "filing" of a registration statement, and therefore no filing fee is due at the time of submission. An issuer that meets the definition of emerging growth company, but was already in the registration process at the time of enactment of the Act, may switch to confidential review for future amendments to its registration statement.

  According to guidance issued by the Division, a foreign private issuer that qualifies as an emerging growth company may generally elect to use either the confidential submission process available to foreign private issuers prior to the enactment of the Act or the confidential review procedures available to emerging growth companies under the Act. However, if such a company chooses to take advantage of *any* benefit available to emerging growth companies, the foreign private issuer may only use the confidential submission procedure prescribed for emerging growth companies.

- **Exception to allow "testing the waters" communications with certain investors**. Under a new exception to section 5 of the Securities Act, emerging growth companies and their representatives may engage in oral and written communications with potential investors[10] that are qualified institutional buyers (as defined in Rule 144A under the Securities Act) or institutions that are accredited investors (as defined in Regulation D under the Securities Act) to determine whether those investors "might have an interest in a contemplated securities offering". These communications can occur prior to or following the filing of any registration statement. This new exception, together with the new rules described below easing the restrictions on the participation of research analysts in the offering process, permit potentially significant changes to the marketing process for securities offerings by emerging growth companies. Although it remains to be seen how far these liberalizations will be taken by market participants, we believe that issuers and underwriters will take advantage of their ability to engage in "testing the waters" activities. Our expectation is that while these activities are permitted at any time before and during the registration process, these activities will commonly occur after an IPO registration statement has been confidentially submitted to, and commented upon by, the SEC staff. We expect the draft registration statement and limited supplemental materials derived therefrom to be the only written materials typically used for purposes of "testing the waters" after a registration statement has been submitted, and we expect that underwriters will wish to conduct due diligence on, and receive representations and warranties from issuers with respect to and indemnity from issuers on, the contents of such

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[6] The Division has advised that the date of the first sale of common equity securities under an effective registration statement could relate to an employee benefit plan or a registered secondary offering, as well as an IPO.

[7] Confidential review is available for a registration statement related to debt securities, *e.g.*, an A/B debt exchange offer on Form S-4, so long as the issuer's first registered sale of common equity has not occurred.

[8] The section refers to a "road show" as defined in Rule 433(h)(4). It was initially unclear whether certain "testing the waters" communications could be considered a road show under Rule 433(h)(4) and trigger a requirement to file the registration statement 21 days before the date of those communications. The Division has stated in guidance materials that they "will not object if an emerging growth company does not treat test-the-waters communications conducted in reliance on new Section 5(d) [of the Securities Act] as a road show for purposes of [new] Section 6(e) [of the Securities Act]". The Division has not stated how issuers will demonstrate reliance on section 5(d) when such testing the waters communications contain the elements of a road show described in Rule 433(h)(4). Emerging growth companies that do not conduct a road show should file their registration statement and confidential submissions no later than 21 days before the anticipated effectiveness of the registration statement.

[9] To facilitate this, issuers will be asked to resubmit their response letters when they file their registration statements on EDGAR. In its response letters during the confidential submission period, an issuer should identify any information that it does not want to become public so that the information is not repeated in comment letters from the SEC staff (which will later become public if the offering is completed). When resubmitting response letters on EDGAR, issuers should follow Rule 83 confidential treatment procedures (alternatively, the Rule 83 procedures can be followed at the time of initial submission of the response letters to the staff).

[10] The guidance issued by the Division provides that for the purposes of "testing the waters" communications, a company that is an emerging growth company when it makes such communications but that is not an emerging growth company at the time of filing a registration statement will not be penalized for such communications.

materials. We do not expect that financial projections or other financial information not included in the registration statement typically will be provided to investors in connection with "testing the waters" activities.

- **Reduced audited financial statement, selected financial data, ratio of earnings to fixed charges and MD&A requirements**. Emerging growth companies may elect to provide only two years (rather than three years)[11] of audited financial statements[12] and correspondingly reduced selected financial data and Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in registration statements related to a common equity IPO.[13] Furthermore, an issuer that qualifies as an emerging growth company when it publicly files its registration statement, but that loses such status prior to effectiveness of the registration statement, would still only have to provide the disclosures required of emerging growth companies. This reduced disclosure does not appear to apply to initial public offerings of debt securities, such as registered exchange offers for debt securities issued under Rule 144A. In any registration statement after its initial public offering of common equity, emerging growth companies may elect to omit selected financial data and MD&A information for any period prior to the earliest period for which audited financial statements were presented in their IPO registration statement. In debt offerings, emerging growth companies need not present a ratio of earnings to fixed charges for any period earlier than the earliest period for which selected financial data is required to be disclosed. Furthermore, the Division has indicated that, in registration statements subsequent to the IPO registration statement, emerging growth companies need not provide audited financial statements for any period prior to those provided in the IPO registration statement. In their annual reports under the Exchange Act, emerging growth companies are required to present three years of audited financial statements, but are not required to present selected financial data for any period earlier than was presented in their IPO registration statement.

  Even though the exemptions described above for selected financial data and MD&A disclosures reference the Regulation S-K provisions that govern filings by registrants that are not foreign private issuers, the Division has indicated that it will not object if a foreign private issuer that qualifies as an emerging growth company complies only with the reduced disclosure requirements under the Act "to the extent relevant to the form requirements for foreign private issuers", the most important of these being the requirements for MD&A and selected financial data disclosures.

Following its IPO, an emerging growth company is granted the following relief:

- **Delayed requirement for SOX 404 audit**. Though they must comply with SOX 404(a), which requires an issuer's management to provide an assessment and report on ICFR, emerging growth companies are not required to obtain an auditors' report on the effectiveness of ICFR. This is similar to the current treatment of non-accelerated filers under SOX 404. Non-accelerated filers (that is, those that are not "large accelerated filers" or "accelerated filers" as defined by Rule 12b-2 under the Exchange Act) must include a management report on the effectiveness of ICFR in their annual reports on Form 10-K and Form 20-F, but not an auditor's report.

- **No requirement for "say on pay", "say on frequency" or "golden parachute" votes**. Emerging growth companies are exempt from the requirement that public companies provide their shareholders with advisory votes (1) on compensation of their named executive officers, (2) on whether such "say on pay" vote should occur every one, two or three years and (3) on executive compensation tied to M&A and other change of control transactions that are presented for shareholder approval.[14]

- **Reduced executive compensation disclosure requirements**. Emerging growth companies are only required to disclose the more limited executive compensation information required to be provided by smaller reporting companies (as defined by Rule 12b-2 under the Exchange Act), including (1) executive compensation disclosure for fewer named executive officers than would be required if the company were not an emerging growth company or smaller reporting company (generally three

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[11] Foreign private issuers that present their financial statements in accordance with IFRS must follow all standards issued by the IASB, which in some circumstances may require three years of balance sheets, even though the earliest balance sheet is not required by the Act itself.

[12] For those emerging growth companies that are required to present financial statements of other entities (*e.g.*, acquired businesses and equity method investees under Rules 3-05 and 3-09 of Regulation S-X, respectively) in their registration statements and that only present two years of the company's audited financial statements, no more than two years of financial statements of such other entities are required in the company's registration statement.

[13] While it was initially unclear whether there would be reduced requirements for selected financial data in IPO registration statements, the Division has issued guidance stating that an emerging growth company that only presents two years of audited financial statements in its IPO registration statement may limit the selected financial data disclosure to the same time period.

[14] Votes on "say on pay" and "say on frequency" must generally be held within the one-year period beginning on the date the issuer is no longer an emerging growth company. However, if a company was an emerging growth company for less than two years after the company's first registered equity sale, the time period for the first "say on pay" and "say on frequency" votes is extended until the third anniversary of such date.

persons rather than five), (2) a summary compensation table for two years, rather than the three years required of issuers generally and (3) no narrative compensation discussion and analysis. Emerging growth companies will also not be required to comply with the yet-to-be implemented requirements of the Dodd-Frank Act to disclose information on the relationship between executive compensation and a company's financial performance or the ratio of the median annual total compensation of all employees to the annual total compensation of the chief executive officer.

- **Delayed implementation of certain new accounting standards**. Emerging growth companies are not required to comply with "any new or revised financial accounting standards"[15] that apply to private as well as public companies until such time as those standards are applicable to private companies (that is, companies that are not "issuers" as defined under SOX)[16]. Any new or revised accounting standards that apply only to public companies will become effective for emerging growth companies immediately upon effectiveness of the standard for other public companies.[17] While emerging growth companies may choose to comply fully with the new or revised financial accounting standards that apply to public and private companies on the schedules pursuant to which those standards apply to public companies,[18] an emerging growth company must make that decision "at the time the company is first required to file a registration statement, periodic report, or other report with the Commission under section 13" of the Exchange Act and the company must advise the SEC of that decision. If an emerging growth company is silent on this election, it will be assumed that the emerging growth company has chosen to take advantage of the delayed implementation schedules available to private companies.[19] The Division has indicated that an emerging growth company should notify the review staff of its decision in this regard in its initial confidential submission or filing.[20] If the emerging growth company has initially elected to accept the accommodation afforded by the Act, the emerging growth company may later choose to follow the presumably more rigorous public company implementation schedules. In that case, the emerging growth company must notify the SEC of that election in its next periodic report or registration statement. Importantly, once an emerging growth company has elected to follow the public company implementation schedules, it may not subsequently reverse that election and choose to comply only with the private company implementation schedules with regard to other future new or revised accounting standards.[21]

- **Exemption from certain PCAOB requirements**. Emerging growth companies are exempt from any rules that the PCAOB may issue in the future requiring mandatory audit firm rotation or requiring that an auditor provide a supplement to its audit report (a so-called Auditor Discussion and Analysis or "AD&A"). The possibility of requiring mandatory auditor rotation and AD&A reports was raised in two separate concept releases issued by the PCAOB in 2011 and each remains under active consideration. The PCAOB has not yet, however, issued any proposed standards in these areas and while its most recently issued Standard-Setting agenda indicates that it may issue a proposal related to the auditor reporting model in the third quarter of 2012, an AD&A is only one of many different ideas being considered in that area. With regard to mandatory auditor

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[15] The SEC staff has explained in its FAQs that the phrase "new or revised financial accounting standards" refers to any updates issued by the Financial Accounting Standards Board ("FASB") (which establishes U.S. GAAP) after April 5, 2012. Because of this, foreign private issuers that are emerging growth companies cannot delay compliance with standards under IFRS, even if the IASB affords delayed implementation for private companies. The SEC staff has confirmed that a foreign private issuer that qualifies as an emerging growth company and reconciles its home country GAAP financial statements to U.S. GAAP may take advantage of any extended transition period for updated U.S. GAAP standards when preparing its U.S. GAAP reconciliation. The SEC staff has made clear, however, that the "delayed implementation" provided by the Act does not allow foreign private issuers that are emerging growth companies to report under a set of standards under their home country GAAP that otherwise applies only to nonpublic entities, nor does it allow foreign private issuers that are emerging growth companies to report under IFRS for Small and Medium-sized Entities.

[16] SOX defines "issuers" as entities that (1) have issued securities registered under section 12 of the Exchange Act, (2) that are required to file reports under section 15(d) of the Exchange Act or (3) file or have filed a registration statement with the SEC; in other words, public companies.

[17] At present, there are several public company U.S. GAAP standards that do not apply to private companies such as those relating to segment disclosure and earnings per share. FASB could choose to promulgate additional "public company only" U.S. GAAP standards in the future.

[18] If an emerging growth company makes the election to comply with the implementation schedules applicable to public companies, it must comply with the implementation schedules applicable to public companies for all new or revised accounting standards.

[19] Reporting companies that qualify as emerging growth companies (that is, companies that are already public and that meet the definitional standards including not having made any registered sales of common equity on or before December 8, 2011) must, based on the face of the language in the Act, make the election in their next periodic or current report, including quarterly reports on Form 10-Q, if they wish to comply with new or revised financial accounting standards on the implementation schedule mandated for public companies (where that schedule differs from the one for private companies).

[20] In cases where an emerging growth company elects to follow the delayed implementation schedule for private companies, it is likely that the reviewing staff will provide comments to the effect that such decision should be disclosed in the prospectus and that risk factor disclosure may be appropriate to alert investors to the delayed implementation schedules and inform them that the emerging growth company's financial statements may not be comparable to financial statements of issuers that follow the implementation schedules applicable to public companies. On the other hand, if an emerging growth company chooses to follow public company implementation schedules, the staff may suggest disclosure that such a decision is irrevocable.

[21] See FAQs #13 and #37 in the Division of Corporation Finance's "Frequently Asked Questions of General Applicability on Title I of the JOBS Act".

rotation, the PCAOB has not indicated any plan for a proposal in its Standard-Setting agenda. Emerging growth companies are also exempt from any other new PCAOB auditing standards adopted in the future unless the SEC decides to apply such rules to them after considering the protection of investors and whether such action will promote efficiency, competition and capital formation.

EASING OF RESTRICTIONS ON IPO RESEARCH ACTIVITIES BY INVESTMENT BANKS RELATED TO EMERGING GROWTH COMPANIES

Under the Act, a broker or dealer is permitted to publish or distribute a research report about an emerging growth company that is the subject of a proposed public offering of common equity,[22] even if the broker or dealer participates in the offering.[23] The Act also prohibits the SEC or any national securities association (currently this refers to the Financial Institution Regulatory Authority or "FINRA") from restricting research analysts from publishing or distributing any research report with respect to the securities of an emerging growth company for a period of time following the date of the first sale of common equity securities under an IPO registration statement or prior to the expiration of any "lock-up" period agreed to with the underwriters in an IPO. Any such report will not be a prospectus and therefore will not provide a basis for liability under section 12(a)(2) of the Securities Act. It could, however, provide a basis for Rule 10b-5 fraud liability under the Exchange Act or SEC enforcement action under section 17 of the Securities Act.

While pre-deal research is fairly common outside the United States, we do not expect pre-deal research or research immediately following pricing to become common in IPOs in the United States. Rather, in light of potential liability concerns and in order for a trading market to develop, we expect that major investment banks will continue to restrict research until a meaningful period has lapsed after the pricing and distribution of an IPO (for example, the 25-day prospectus delivery period under Rule 174). We believe that it is likely, however, that the elimination of the current restriction on the distribution of research during the "quiet period" prior to the expiration of any "lock-up" period will be utilized by research analysts to publish during this period without limitation.

In connection with an IPO of an emerging growth company, the Act provides that neither the SEC nor any national securities association may restrict (1) employees of a broker or dealer or members of a national securities association from arranging communications between an analyst and potential investors or (2) an analyst from participating in communications with management that are attended by non-analyst employees of a broker or dealer or members of a national securities association. Though these provisions will limit somewhat FINRA's ability to make and enforce certain rules, other FINRA rules will still apply, such as the restriction on discussions between research analysts and investment bankers regarding research content. Also, banks subject to the Global Research Analyst Settlement will not be relieved from restrictions imposed by the settlement unless the settlement order is amended.[24]

GENERAL SOLICITATIONS TO BE PERMITTED IN RULE 144A OFFERINGS AND PRIVATE PLACEMENTS

In connection with a Rule 144A private sale of securities, companies are currently only permitted to make offers and sales to persons who are reasonably believed to be qualified institutional buyers. The Act requires the SEC to modify Rule 144A to permit a seller to *offer* securities to a non-qualified institutional buyer, including by means of general solicitation or general advertising. However, *sales* under Rule 144A still will be restricted to persons reasonably believed to be qualified institutional buyers.

Notably, the Act does not require the SEC to extend this relief to "directed selling efforts" in the United States in connection with Regulation S transactions occurring offshore. As a result, in a "pure" Regulation S transaction or a transaction that has both a Rule 144A component and a Regulation S component, parties will need to consider whether their communications plan will satisfy the stricter limitations on communications in the United States contained in Regulation S. The SEC may address this in the rulemaking required by the Act.

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[22] The Act provides that a "research report" is a written, electronic or oral communication that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient on which to base an investment decision.

[23] The Division's guidance suggests that brokers or dealers that publish or distribute research reports about an emerging growth company in reliance on this provision will not be penalized if, after the publishing or distribution of such research report, such company loses emerging growth company status.

[24] The SEC could implement such an amendment unilaterally, although it is not clear that such an action is likely.

In connection with a private placement made in accordance with Rule 506 of Regulation D, a company is currently not permitted to offer or sell securities by any form of general solicitation or general advertising (including any advertisement, article or notice in any newspaper, magazine or similar media or broadcast over television and radio, or any seminar or meeting whose attendees were invited by any general solicitation or general advertising). The Act requires the SEC to modify Rule 506 so that the restriction on general solicitation and general advertising will not apply to private placements made under Rule 506, provided that all purchasers are accredited investors. Notably, the Act does not require the SEC to extend this relief to private placements that do not satisfy the requirements of Rule 506 but still qualify as private placements under section 4(a)(2)[25] of the Securities Act.

The Act also provides that with respect to private placements made pursuant to Rule 506 of Regulation D, a person meeting certain qualifications will not be subject to registration as a broker or dealer solely because (1) that person maintains a platform or mechanism that permits the offer, sale, purchase or negotiation of securities, or permits general solicitations, general advertisements or similar activities by issuers of securities, (2) that person or any person associated with that person co-invests in such securities or (3) that person or any person associated with that person provides ancillary services[26] with respect to such securities. The safe harbor will only apply if the person and each person associated with that person (a) do not receive compensation in connection with the purchase or sale of the securities, (b) do not have possession of customer funds or securities in connection with the purchase or sale of the securities and (c) are not subject to a “statutory disqualification”, which includes expulsion or suspension, with respect to membership or participation in, or association with a member of, a self-regulatory organization.

NEW CATEGORY OF EXEMPT SECURITIES

The Act creates a class of exempt securities pursuant to section 3(b) of the Securities Act. The SEC is directed to adopt rules to create this new exemption on the following basis:

- The securities may be issued up to an aggregate amount which, when added to the amount of the same securities issued during the previous 12 months, does not exceed $50 million.[27]
- The securities may be equity, debt, debt convertible or exchangeable for equity and related guarantees.
- The securities will not be restricted securities and may be offered and sold publicly without registration under the Securities Act.
- The securities will be exempt from state Blue Sky laws if offered and sold on a national securities exchange or if offered or sold to a qualified purchaser (as defined by the SEC).
- The issuer must file an offering statement including audited financial statements and other information and must file periodic reports.

CROWDFUNDING

The Act creates a “crowdfunding” exemption from registration, whereby small aggregate amounts of securities of an issuer can be sold through brokers or “funding portals” to investors in small individual amounts. The crowdfunding exemption requires the SEC to create by rule a substantial regulatory framework. Securities issued under the crowdfunding exemption will be subject to the following:

- Transfer of securities issued in crowdfunding transactions will be restricted for one year, with limited exceptions.

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[25] Formerly section 4(2).

[26] The Act defines “ancillary services” as (1) the provision of due diligence services, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors and (2) the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.

[27] The SEC must evaluate the amount at least every two years and has the authority to raise the amount.

- Securities issued in a crowdfunding transaction are "covered securities" under the Securities Act (*i.e.*, exempt from state Blue Sky laws with respect to the issuance of the securities).

- Securities issued in crowdfunding transactions will not count toward the registration thresholds of section 12(g) of the Exchange Act, subject, however, to any conditions that the SEC may impose through rules.

Restrictions on crowdfunding transactions include:

- The aggregate amount sold by an issuer, when added to the amount of securities previously sold by the issuer in reliance on the crowdfunding exemption, must not exceed $1 million.

- The aggregate amount sold in the previous 12 months to an individual investor by an issuer pursuant to the exemption is limited to

  - the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and

  - 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.[28]

- Crowdfunding transactions must be conducted through a broker or funding portal (a specially created intermediary for crowdfunding transactions).

- Crowdfunding is not available for foreign issuers; issuers that are required to file reports pursuant to section 13 or 15(d) of the Exchange Act; investment companies as defined in section 3 of the Investment Company Act, or that are excluded from the definition of investment company by section 3(b) or 3(c) of that Act; and other categories of issuers designated by the SEC as prohibited.

- Issuers and intermediaries must fulfill a number of other requirements, including several related to disclosure and investor education.

On April 23, 2012, the SEC issued a statement reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws today until the SEC has adopted rules implementing the requirements of the Act in this regard.

THRESHOLDS FOR REGISTRATION UNDER SECTION 12(g) OF THE EXCHANGE ACT

The Act amends section 12(g) of the Exchange Act to provide that an issuer must register a class of equity securities under the Exchange Act if on the last day of the preceding fiscal year[29] it has:

- total assets exceeding $10 million; and

- a class of equity securities held of record by either

  - 2,000 persons, or

  - 500 persons who are not accredited investors.

Separate rules apply for banks and bank holding companies.[30] The previous statutory thresholds were total assets exceeding $1 million and 500 persons, respectively. The Act does not change the threshold to terminate registration of securities (except

[28] It is not clear which limit would apply to an individual investor who had at least $100,000 in net worth or annual income, but not both.

[29] Guidance from the Division provides that those issuers with a fiscal year ending before April 5, 2012 that triggered the obligation to register under the prior holder of record threshold but would not do so under the new requirements are no longer obligated to register under section 12(g).

[30] Under the Act, banks and bank holding companies must register if they have $10 million of total assets and 2,000 holders of record.

for banks and bank holding companies), so that a company that is not a bank or bank holding company may not terminate registration of a class of equity securities unless those securities are held of record by fewer than 300 persons (1,200 persons for banks or bank holding companies).

Importantly, the Act does not alter the limited "look-through" provisions that apply to section 12(g) of the Exchange Act, except as noted below. As a result, for shares held through the Depository Trust Company, issuers are generally not required to look beyond the firms that are participants in the DTC system. Shares held by these firms could represent the beneficial interests of a much larger number of persons. At the same time, however, the Act does not provide guidance on how an issuer is to determine whether its direct holders qualify as accredited investors. The practical value of the change in the thresholds will be substantially reduced if issuers are not given some basis to make a reasonable determination as to holder status without having to make specific inquiry.

The Act provides that, for purposes of section 12(g) of the Exchange Act, securities "held of record" do not include securities held by persons who received the securities as part of an employee compensation plan in a transaction exempt from registration under the Securities Act (*e.g.*, Rule 701). Securities issued in a crowdfunding transaction (discussed earlier) are exempt from the provisions of section 12(g), though the SEC may place conditions on this exemption by rule. Furthermore, the SEC is directed to adopt safe harbor provisions that issuers can follow when determining whether securities were received pursuant to an employee compensation plan in qualifying exempt transactions. However, the subsequent transfer of such securities may give rise to additional holder of record calculation issues.

Notably, the Act also directs the SEC to study whether new enforcement tools are needed to enforce the "anti-evasion" provisions of the holder of record rules.

OTHER PROVISIONS

The Act directs the SEC to study the transition to the decimalization (one-penny increments, rather than fractional amounts) of trading and quoting securities and its effects on small and mid-sized companies. The SEC is given authority to make changes to these amounts for such companies.

The Act directs the Comptroller General to conduct a study on state laws regulating securities offerings pursuant to Regulation A.

The Act directs the SEC to conduct a review of Regulation S-K to analyze the requirements of the regulation and to determine how those requirements can be updated to modify and simplify the registration process and reduce costs for emerging growth companies. The SEC must submit a report to Congress that includes its findings as well as recommendations on how to streamline the registration process in order to make it more efficient and less burdensome for the SEC and for prospective issuers that are emerging growth companies.

The SEC is directed to provide online information to inform small- and medium-sized businesses, women-owned businesses, veteran-owned businesses and minority-owned businesses of changes made by the Act.

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