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The JOBS Act: What It Means for Capital Markets Practices and Capital-Raising Strategies

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Introduction

The Jumpstart Our Business Startups Act (JOBS Act) was signed into law by President Obama on April 5, 2012, after quickly working its way through both houses of Congress with overwhelming bipartisan support. The goal of the JOBS Act is to promote capital formation in the United States by making it easier for emerging growth companies (EGCs) to go public, and by otherwise facilitating the ability of both public and private companies (both EGCs and non-EGCs) to raise capital. An underlying theory of the JOBS Act legislation is that by facilitating capital formation, including through initial public offerings (IPOs), companies will be able to grow and expand their businesses, which, in turn, can result in additional job creation and economic growth.

As a result of the JOBS Act, privately held companies may want to take a fresh look at whether they want to go public. In addition, any company (public or private) looking to raise capital will want to reevaluate its capital-raising options in light of the JOBS Act. For EGCs, going public and complying with the obligations of being a public company should be somewhat easier, as well as less costly and less burdensome. For private companies who want to remain private, the JOBS Act makes it much easier to do so.

The IPO On-Ramp and Benefits to EGCs

It is estimated that 90 percent or more of all companies going public will qualify as EGCs entitled to benefit from the "IPO On-Ramp" provisions contained in the JOBS Act. Emerging growth companies are defined in the JOBS Act as companies having less than $1 billion in annual gross revenues for its most recently completed fiscal year. The $1 billion amount is to be adjusted for inflation every five years. Companies that went public or otherwise first sold common equity securities pursuant to a registration statement under the Securities Act of 1933 on or before December 8, 2011, are not eligible to be EGCs.

The benefits of being an EGC include, among others, reduced financial and executive compensation disclosure requirements, relief from the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002,[1] the ability to delay adoption of certain new and revised

[1] 15 U.S.C.A. § 7262 (West 2012).

accounting standards, and a number of IPO procedural changes that should facilitate the ability of EGCs to go public.

With respect to reduced financial disclosures, EGCs will be required to include only two years of audited financial statements, instead of three years, in their IPO registration statements. In addition, EGCs will be able to present fewer years of selected financial information and management's discussion and analysis disclosures. In the compensation disclosure area, EGCs will not need to include a "compensation discussion and analysis" in their IPO registration statement or in their annual reports or proxy statements filed with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. In addition, EGCs will be able to present fewer years of compensation disclosure covering a reduced number of executives. EGCs will also be free from some of the other compensation-related requirements applicable to non-EGC SEC reporting companies, such as "Say on Pay" and "Say on Golden Parachute" votes, which provide shareholders with non-binding votes on executive compensation.

Another very significant benefit to EGCs is that they will not have to have their auditors attest to the adequacy of their internal control over financial reporting under Section 404(b) of Sarbanes-Oxley.[2] EGCs will still need to maintain, and their management will still need to certify to, internal control over financial reporting. In addition, EGCs will be entitled to comply with new and revised accounting standards on the same timeframe as private companies in the case of accounting standards that are applicable to both public and private companies.

All of the foregoing changes are intended to make it easier, less burdensome, and less expensive for an EGC to go public and to comply with its public company reporting obligations for the first several years it is a public company. EGCs will be able to take advantage of these benefits for up to five years following their IPO, although in certain circumstances a company may cease to qualify as an EGC earlier (for example, if the market value of the EGC's common stock held by non-affiliates exceeds $700 million, or if the EGC issues more than $1 billion of debt over a three-year period).

[2] *See id.*

The JOBS Act also makes significant changes with respect to the IPO process for EGCs. For one thing, EGCs are now able to confidentially submit drafts of their IPO registration statements and amendments for review by the SEC, so long as the registration statement and all amendments submitted confidentially are publicly filed at least twenty-one days prior to the commencement of the "roadshow" relating to the EGC's IPO. This confidential submission process allows EGCs to start the SEC review process for its IPO without public scrutiny and without needing to make public disclosure of its IPO plans and commercially sensitive information until such time as the EGC has greater confidence that it will be able to successfully complete its IPO. In addition, EGCs and their underwriters are now able to engage in "test the waters" activities with qualified institutional buyers and institutional accredited investors, both before and after a registration statement is filed, for the purpose of determining investor interest in an IPO and in other securities offerings by an EGC. The "test the waters" provisions are expected to have a significant impact on the way IPOs are marketed. Among other things, the test the waters provisions will be helpful in determining whether and when to proceed to market with an IPO, in setting the proposed size and price range of the IPO prior to launching the roadshow, and in identifying potential anchor or cornerstone investors for the IPO. The JOBS Act also makes changes in the area of investment banking research. These changes, which are discussed more below, are intended to facilitate research coverage on EGCs and research analyst communications with management of EGCs and with investors in connection with EGC IPOs.

Impact of the JOBS Act on the Publication of Securities Research on EGCs and Research/Investment Banking Interaction

The JOBS Act makes a number of noteworthy changes in the research area that are intended to make it easier for securities analysts to publish research on EGCs. In particular, it will now be possible for investment banks, including investment banks participating as an underwriter in an EGC's IPO, to publish research on an EGC both in advance of its IPO and sooner following completion of the IPO. This is as a result of the JOBS Act amendment of Section 2(a)(3) of the Securities Act to provide that research on an EGC that is the subject of a proposed public offering of common equity securities is not an "offer" or a "prospectus" for purposes of Section 5(c) and Section 2(a)(10) of the Securities Act, as well as the elimination by the JOBS Act of certain mandated post-IPO blackout periods on research.[3] It remains to be seen as to what degree investment banks will look to take advantage of this new flexibility, particularly investment banks participating as underwriters in an EGC's IPO. It has been fairly common in Europe and elsewhere in the world outside the United States for investment banks participating as underwriters to publish pre-IPO research. However, this has not previously been permissible in the United States. The US litigation climate is very different from the litigation climate in the rest of the world, particularly with respect to class action securities litigation. Because securities research that is published is potentially subject to anti-fraud liability, including under Rule 10b-5,[4] it remains to be seen whether investment banks participating as underwriters will seek to publish research in advance of or within days following an IPO. While 10b-5 liability requires a finding of scienter (generally, intentional misconduct or recklessness), the mere prospect of potential litigation may be a deterrent to publishing research. On the other hand, some investment banks may view the publication of pre-IPO research as providing a competitive advantage. With respect to issuers who provide input to research analysts publishing research in close proximity to an IPO, they need to be mindful of potential issuer entanglement issues that could give rise to potential liability on their part.

The JOBS Act also seeks to make it easier for research analysts to engage in discussions with investors and with EGC management in connection with EGC IPOs by permitting investment banking personnel to arrange for communications between research analysts and investors in connection with EGC IPOs, and by permitting research analysts to attend meetings with management of EGCs at which investment banking personnel are also present. This is as a result of the JOBS Act amendment of Section 15D of the Exchange Act, which was added as part of Sarbanes-Oxley and relates to research analyst conflicts. However, numerous questions remain regarding how these JOBS Act provisions are to be interpreted, and how they affect and interact with other existing rules governing research analyst conflicts of interest. In addition, the JOBS Act does not modify the Global Settlement entered into in 2003 between a number of investment banks and the SEC, the National Association of Securities Dealers (now the Financial Industry Regulatory Authority), the New York Stock Exchange, the New York State

[3] *See* 15 U.S.C. 77b(a) (West 2012).
[4] 17 C.F.R. § 240 (2000).

Attorney General (then Elliot Spitzer), and certain other state securities regulators. The implications of the JOBS Act on the Global Settlement remain uncertain at this time.

Among the regulations relevant to research analyst conflicts of interest and the publication of research are NASD Rule 2711,[5] NYSE Rule 472,[6] and the SEC's Regulation AC.[7] These regulations, among other things, restrict the clearance of research by investment banking personnel, restrict investment banking personnel from supervising and determining compensation of research personnel, provide that investment banking personnel cannot retaliate against research analysts for publishing negative or unfavorable research, mandate blackout periods restricting the publication of research by underwriters during certain periods following public offerings, require firewalls between research and investment banking, and require certain conflict of interest disclosures in and research analyst certification of research reports. While much of these regulations remain unaffected by the JOBS Act, the interplay between the JOBS Act and certain provisions contained in these regulations is still uncertain. For example, it remains to be seen whether the provisions of the JOBS Act will be construed to permit research analysts to appear with investment banking personnel at investment banking pitches and roadshow meetings, or whether these activities will remain prohibited. In addition, while the JOBS Act will generally eliminate research blackout periods following an EGC IPO (including around the expiration of lock-up agreements entered into in connection with an EGC IPO), there are certain ambiguities in this provision of the JOBS Act that require clarification by the Financial Industry Regulatory Authority.

As noted above, the JOBS Act does not expressly modify the Global Settlement. Under the Global Settlement, the settling investment banks paid significant monetary penalties and agreed to a number of significant structural reforms intended to address conflicts of interest between research and investment banking. The terms of the Global Settlement required the settling investment banks to physically separate research from investment banking and maintain separate reporting lines and legal and compliance staff, required that

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[5] NASD Rule 2711, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p000446.pdf

[6] NYSE Rule 472, *available at* http://www.nyse.com/pdfs/rule472.pdf.

[7] 17 C.F.R. §§ 242.500-242.505.

securities analyst compensation could not be based on investment banking revenues or input from investment banking personnel, mandated that investment bankers have no role in company-specific research coverage decisions, prohibited research analysts from participating in efforts to solicit investment banking business (including participation in pitches and roadshows), required that the investment banking firms implement policies to ensure that investment banking personnel do not seek to influence research for the purpose of obtaining investment banking business, and required the firms to maintain firewalls between research and investment banking. The Global Settlement also required conflicts of interest disclosures to be included in research reports and certain other changes. While some provisions of the Global Settlement were subsequently modified because they were deemed to have otherwise been adequately addressed in NASD Rule 2711 and NYSE Rule 472, most of these Global Settlement provisions continue to be in effect and, absent modification, may preclude the investment banks that are party to the Global Settlement from being able to fully realize the flexibility the JOBS Act might otherwise afford in the research area. In addition to the banks that are party to the Global Settlement, there are other investment banks that, even though they are not parties, voluntarily adhere to the Global Settlement as best practices or because some of their important customers insist on it.

Under the terms of the Global Settlement, the SEC has the authority to adopt rules that expressly override provisions of the Global Settlement. It remains to be seen whether the SEC might use this authority to facilitate some of the changes intended by the JOBS Act in the research area. If the SEC does not do this, the parties to the Global Settlement could seek court approval of modification of the terms of the Global Settlement. If the terms of the Global Settlement are not modified, there is a possibility that an uneven playing field and divergent market practices may develop, with investment banks not bound by or otherwise complying with the Global Settlement engaging in practices that are different from those of the investment banks that are subject to or voluntarily comply with the Global Settlement.

As of July 31, 2012, neither the SEC nor the Financial Industry Regulatory Authority had given public guidance with respect to how they intend to interpret the JOBS Act provisions and modify existing regulations in the research area, nor had they expressed publicly their views as to how the JOBS Act affects the Global Settlement. As a result, investment banks have been proceeding cautiously thus far in terms of making changes to their policies and practices in the research area. This is an area that will likely evolve over time, however, and something people should keep an eye on.

The JOBS Act and Changing Capital-Raising Strategies

In light of the JOBS Act, many companies should be thinking about their capital-raising strategies and how changes brought about by the JOBS Act affect the thought process in this area.

For example, a private company or its controlling shareholders considering exit strategies or a liquidity event might now view going public as a more attractive, or at least a more viable, option. Companies or controlling stockholders who may have been looking exclusively or primarily at a merger and acquisition exit strategy might want to reconsider the IPO option or a dual-track IPO/merger and acquisition strategy. Foreign companies, many of whom had written off a US IPO as a possibility because of Sarbanes-Oxley-related concerns, might view the changes brought about by the JOBS Act as attractive enough to pursue or at least once again consider a US IPO. And because the JOBS Act's EGC definition will capture most of the companies going public in the United States, all private companies looking at a possible IPO should be considering how the JOBS Act will affect their IPO strategy and process.

In addition to making it easier to go public, the JOBS Act has also made changes that will make it easier to raise capital privately. Specifically, with respect to Rule 506 private placements to accredited investors under Regulation D and Rule 144A offerings to qualified institutional buyers, the JOBS Act requires the SEC to engage in rule-making that will eliminate the historical prohibitions on general solicitation and advertising in connection with those offerings.[8]

Other changes brought about by the JOBS Act include the introduction of "crowd-funding," which will permit domestic private companies to raise up to an aggregate of $1 million in a twelve-month period from a large number of investors. The JOBS Act will also result in a new $50 million small offering exemption under newly added Section 3(b)(2) of the Securities Act (which is

[8] *See* 17 C.F.R. §§ 230.506, 230.144(a).

also being referred to as Regulation A+).[9] Both the new crowd-funding exemption and Regulation A+ require SEC rule-making before they take effect. However, once that occurs, both of these present should new and exciting new capital-raising opportunities. In particular, crowd-funding may be very attractive to early-stage privately held companies and smaller businesses as a way to raise start-up capital, while Regulation A+ has the potential to be a new pathway for smaller IPO-like offerings of less than $50 million. With respect to Regulation A+, it is worth noting that it has become quite rare to see IPOs in the $25 to $50 million range. Companies that might pursue an IPO of that size are often thought to be too small to stage an IPO successfully. In addition, many of the smaller boutique investment banks that once catered to smaller growth-oriented companies, such as in the technology and biotechnology industries, have disappeared in the last ten to fifteen years—either as a result of having been acquired by larger investment banks or because they otherwise simply disappeared from the landscape. Regulation A+ could bring back a viable market for smaller company IPO-like transactions. These transactions will likely be much less burdensome for companies to undertake than a traditional IPO and should be looked at as a possible alternative for smaller companies once the SEC adopts rules in this area.

The JOBS Act also raises the shareholder threshold at which a private company is required to register with the SEC and become an SEC reporting company under Section 12(g) of the Exchange Act.[10] Previously, a company with more than $10 million in assets and 500 or more shareholders of record was required to register with the SEC and become an SEC reporting company. The 500 shareholder threshold created significant risk that a company would be required to start publicly reporting with the SEC earlier than it might otherwise want to. As a result of the JOBS Act, for most companies the shareholder threshold has been raised to 2,000 shareholders of record or 500 non-accredited investors (for banks and bank holding companies, the shareholder threshold was changed to 2,000 shareholders of record). In addition, under the JOBS Act, employees who receive shares as part of a compensation plan will be excluded from the Section 12(g) shareholder of record count.[11] The same will be true of shares acquired in crowd-funding transactions. These changes will make it much easier for private companies to stay under the shareholder cap for a

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[9] Section 3(b)(2) of the Securities Act.
[10] Securities Exchange Act of 1934 Section 12(g), *available at* http://www.sec.gov/about/laws/sea34.pdf.
[11] *See id.*

longer period of time. As a result, many companies are likely to rethink their strategies with respect to going public or staying private, simply because it will be easier to stay private longer.

There is some internal tension among the various provisions of the JOBS Act. On the one hand, the IPO On-Ramp provisions make it easier for EGCs to go public and are intended to stimulate IPOs. On the other hand, the general solicitation and advertising changes in the private placements area will make it easier for both public and private companies to raise capital privately, while the increase in the Section 12(g) shareholder threshold makes it easier for companies to stay private longer. Add to this the new crowd-funding and Regulation A+ options that will be available to some companies, and it is clear that the JOBS Act will require both public and private companies and the investment banks that work with them to reconsider the various options in the capital-raising toolkit when evaluating what capital-raising strategies make the most sense.

Upcoming Rule-Making and Evolution of Market Practices in Response to the JOBS Act

The IPO On-Ramp portion of the JOBS Act was effective upon enactment. In addition, the staff of the SEC's Division of Corporation Finance has issued several sets of frequently asked questions and provided other interpretive guidance in this area. As discussed above, one aspect of the IPO On-Ramp where a significant number of interpretive and other issues remain is in the research area. This is an area where guidance is needed from the SEC and the Financial Industry Regulatory Authority. Another part of the JOBS Act that took effect immediately was the Section 12(g) shareholder threshold changes.[12] The SEC has also issued frequently asked questions relating to this portion of the JOBS Act.

Other portions of the JOBS Act require rule-making before they take effect. Under the JOBS Act, the SEC was required to adopt rules eliminating the prohibitions on general solicitation and advertising in connection with Rule 506 and Rule 144A offerings by July 4, 2012 (ninety days after enactment of the JOBS Act).[13] As of July 31, 2012, this rulemaking had not yet occurred. In the crowd-funding area, rule-making by the SEC is required by December

[12] *See id*.
[13] *See* 17 C.F.R. §§ 230.506, 230.144(a).

31, 2012 (270 days after the JOBS Act was enacted). The JOBS Act does not specify a mandated timeframe for rule-making with respect to the Section 3(b)(2)/Regulation A+ small offering exemption, so it is uncertain when those rules will be forthcoming.[14] Because the SEC is still working to complete required rule-making under the Dodd-Frank Act and is behind schedule on many of those, it is not a given that the SEC will hit mandated deadlines for rule-making specified in the JOBS Act (as evidenced by the SEC not hitting the July 4, 2012 general solicitation rulemaking deadline).

Market practice itself is and will continue to develop in response to the JOBS Act. Given the newness of the legislation, the need for rule-making and guidance in certain areas, and various uncertainties with respect to some of its provisions, practices can be expected to evolve over time. For example, while many EGCs are already taking advantage of the confidential submission process with respect to SEC review of IPO registration statements, to date there has not been any significant change in market practice in the research area. In addition, practices in the "test the waters" area are only just starting to develop. And because SEC rule-making is required in the general solicitation and advertising area with respect to private placements, as well as with respect to crowd-funding and Regulation A+, it is too early to predict with certainty how market practices will develop and evolve in these areas.[15]

Capital markets and securities law practitioners, as well as their clients who are or expect to engage in capital-raising activity or who advise companies on capital-raising activities, should continue to monitor JOBS Act developments in the weeks and months ahead.

Conclusion

The JOBS Act is an exciting development in the capital markets area, and it should greatly enhance the ability of companies to raise capital. The speed with which the legislation moved through Congress and the overwhelming bipartisan support for the legislation is virtually unprecedented these days. We are still in the early days, and it remains to be seen how market practices will change in response to the JOBS Act. However, it is certain that the JOBS Act will result in changes to market practice, in some cases

[14] *See* Section 3(b)(2) of the Securities Act.
[15] *See id.*

significantly. In fact, this is already happening with respect to some aspects of the JOBS Act. Companies and their advisors need to be cognizant of the changes brought about by the JOBS Act, and consider how these changes affect their capital-raising strategies.

Key Takeaways

- For practitioners working with private companies evaluating a possible IPO or other exit strategies, they should be aware that staging an IPO in the United States is now a potentially more attractive option. Under the JOBS Act, it should now be easier for companies that are EGCs to go public and comply with their public company obligations.
- For practitioners who work on IPOs, they need to be aware of how IPO market practices are and will continue to evolve, including with respect to the SEC's confidential registration statement submission process, market acceptance of changes now permitted under the JOBS Act (such as reduced financial disclosures, Sarbanes-Oxley 404(b)[16] internal control practices, reduced compensation disclosures, etc.), and how "test the waters" practices and research-related practices evolve.
- For practitioners working with companies, public or private, evaluating raising capital, they should be aware of the additional flexibility the elimination of prohibitions on general solicitation and advertising will provide under Rule 506 of Regulation D and under Rule 144A, and how that might affect market practices with respect to these offerings and the attractiveness of these offerings relative to a public offering.[17]
- For practitioners working with smaller companies (particularly private companies) looking to raise capital, they need to consider how the crowd-funding and Regulation A+ capital-raising options will affect the capital markets toolkit and capital-raising strategies.[18]
- Practitioners working with private companies need to understand the Section 12(g) changes, and how the increased flexibility to remain a private company longer affects the "go public versus stay private" decision-making process.[19]

[16] 15 U.S.C.A. § 7262 (West 2012).
[17] *See* 17 C.F.R. §§ 230.506, 230.144(a).
[18] *See* Section 3(b)(2) of the Securities Act.
[19] *See* Securities Exchange Act of 1934 Section 12(g), *available at* http://www.sec.gov/about/

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