JOBS Act Passed, Now What? 5 things Mature Companies & Entrepreneurs Need to Think About

By: Kaiser Wahab and Lauren Mack

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act), which makes substantial changes securities laws by making it easier for startups and small businesses to raise funds, stay private longer, and avoid or delay some of the burdens that come with taking a company public. The various provisions of the JOBS Act will come into effect over the course of 2012, culminating with the SEC's much-anticipated crowdfunding rules being issued by the SEC at the end of the year. Below we brief you on the most important provisions of the JOBS Act and what you as an entrepreneur should be thinking about now to take advantage of these changes in the future.

1. Cap on Private Equity Holders Increased

What You Should Be Thinking About Now:

Consider whether your company's organizational documents and related shareholder or investor rights agreements need to be revised in light of the revised shareholder threshold and possibility of increased secondary sale activity.

Before:

Private issuers would have to register a class of securities with the SEC if they were held of record by 500 people or more, which would also subject them to the burdensome reporting obligations of public companies.

After:

The JOBS Act increases the threshold from 500 to 2,000 holders of record, as long as no more than 499 of those 2,000 holders of record are not "accredited investors." Excluded from this calculation are those who obtained equity under the company's equity compensation plans and investors who purchased securities pursuant to the crowdfunding exemption discussed below. This allows companies to avoid going public longer and to freely give equity compensation to employees without the fear of being forced to register as a public company. The ability of more companies to stay private longer may also lead to a more robust secondary market for shares of private companies than currently exists.

Effective:

Immediately, although there is no deadline for the SEC to adopt rules to change the definition of "held of record."

2. Some General Solicitation Prohibitions Eliminated

What You Should Be Thinking About Now:

If your private company is looking to raise capital under the Rule 506 exemption, start thinking about how you will let the right people know about your company and its goals. Will you contact accredited investors directly, send the information to investing communities and email lists, contact websites and blogs whose readership includes people interested in your product or service, use social media tools, or some combination of these methods? Companies should also consider what impact these methods may have on the company's image or credibility and ability to attract desirable investors.

Before:

Private companies that sell equity often rely on the exemption from registration with the SEC under Rule 506 of Regulation D. In exchange for lifting the burden of registering securities, any exemption under Regulation D does not allow the issuer to engage in general solicitation or advertising of the offering. This means that there must be a "pre-existing relationship" between the offeror and the offeree, and one offer without such a relationship would make the exemption inapplicable and trigger the registration requirement.

After:

The JOBS Act amends Rule 506 to allow general solicitation or advertising if all purchasers qualify as "accredited investors" under SEC rules. By eliminating any restrictions on who the securities may be offered to, issuers may now announce that they are seeking funding to anyone, including through a website or email, without worrying about losing the exemption. This greatly widens the pool of potential investors for private companies, especially those without wealthy friends. Issuers must take "reasonable steps" that will be determined by the SEC to verify that all purchasers are accredited investors.

Effective:

By July 4, 2012 (90 days after enactment).

3. Fewer Burdens on "Emerging Growth Companies"

What You Should Be Thinking About Now:

If you see your company going public in the future, consider the new benefits of going public while your company qualifies as an EGC. The scaled disclosures, regulatory requirements, and more limited governance obligations of an EGC will reduce the costs of going public, and the enhanced confidentiality in the registration process allow an EGC to resolve presentation and disclosure issues in its registration statement out of the public eye.

Before:

Previously, all companies were subject to the same IPO procedures and reporting obligations, regardless of revenue or other factors.

After:

The JOBS Act introduces the "Emerging Growth Company" (EGC), which is a company with less than $1 billion in revenue. The regulatory burdens that come with going public are reduced for EGCs, and certain SEC compliance measures are phased in over time. Any issuer that priced its IPO before December 9, 2011 does not qualify as an EGC.

• The IPO perks given to EGCs include:
• Only two years of audited financials will need to be provided, instead of three years, with no selected financial data for prior periods;
• The ability to make pre-filing offers to investors to "test the waters," without the current "gun-jumping" restrictions on pre-offering communications;
• Investment banks will be permitted to publish research reports about an EGC immediately after they become public companies;
• The ability to begin the SEC registration process on a confidential basis; and
• Certain governance and disclosure requirements are scaled back for up to five years for newly public EGCs, including:
• An exemption from "say-on-pay" votes;
• A more limited executive compensation disclosure;
• An exemption from being required to hire an independent auditor to attest to the company's internal financial controls; and
• Longer phase-in periods for new or revised financial accounting standards.
• A company remains an EGC until the earlier of:
• Achieving annual gross revenue in excess of $1 billion;
• The fifth anniversary of its IPO;
• Issuing more than $1 billion in non-convertible debt during a three-year period; or
• Becoming a "large accelerated filer" with at least $700 million in public float.

Effective:
Immediately.
4. Crowdfunding Made Easier
What You Should Be Thinking About Now:
Consider whether obtaining investors through crowdfunding is the right choice for your company. Is your company's management willing and able to communicate regularly and openly with a large number of investors? Anticipate frequent telephone calls and emails from frustrated investors, your company and management to be discussed in Internet chat rooms in potentially graphic terms, and your competitors to download your disclosure documents from the SEC to use your company's financial statements and disclosures about risks against it in the marketplace.
If your company's management is prepared to deal with all that comes with a large number of investors and public offering documents, think about beginning to prepare your disclosure documents now. Harmonize your disclosure documents with your website and marketing literature, make sure financial statements and tax returns are in order, have background checks done on the company owners to avoid surprises during the offering, and start figuring out how to describe the risks of investing in your business in plain, meaningful language. The SEC will be very concerned about fraud, especially in the early years of the exemption, so you do not want to give any of your many investors a reason to claim you did not make adequate risk disclosures. You should also be prepared for considerable variations in price and functionality among the new crowdfunding intermediaries at first, as it will take time for standard practices to emerge.

Before:
Currently, there is no way for a private company to give an investors equity stake in the company through crowdfunding without seriously violating securities laws. Crowdfunding must websites characterize the money that entrepreneurs raise as "donations," for which the donors may receive various tokens such as stickers or a t-shirt, but may not receive equity in the company itself.
After:
The JOBS Act requires the SEC to create a new exemption that allows issuers to raise $1 million through crowdfunding transactions within any 12-month period. This limit will be adjusted by the SEC at least every five years to reflect changes in the Consumer Price Index. There will not be a limit to the number of investors that a company may have through the exemption, although the SEC is allowed to impose some restrictions. The amount that an individual investor may invest depends on his or her annual income or net worth. If either is less than $100,000, the investor's investment in any one issuer may not exceed the greater of $2,000 or 5% of the investor's annual income or net worth. If either equals or exceeds $100,000, then the investor's investment in any one issuer is limited to 10% of the investor's annual income or net worth, up to a limit of $100,000.
Issuers must use either a securities broker or a "funding portal" as an intermediary to find prospective investors, but they may publish notices and direct investors to the intermediary elsewhere if they do not advertise the terms of the offering. Intermediaries must register with the SEC, provide disclosures to investors regarding the level of risk of the offering, "positively affirm" that each investor understands that the investor is risking the loss of the entire investment and can bear that loss, ensure that no investor invests more than permitted under the exemption, take measures to reduce the risk of fraud, and comply with other SEC regulations.

Issuers will still be subject to anti-fraud rules, and all investors will have the right to recover his or her entire investment, with interest, if the issuer made any material misstatement or omitted some material information from the offering documents. Basic information must be filed with the SEC, including names of directors and officers and holders of more than 20% of the company's shares and a description of the business and financial condition, unless the company also obtains funding through another exemption. States may not adopt registration or offering requirements for securities issued under the crowdfunding exemption (known as "Blue Sky Laws"), and only the state in which the issuer's principal place of business is located and any other state in which purchasers of at least 50% of the aggregate amount of the issue are residents may require any notice filing or filing fee.

Effective:
By December 31, 2012 (270 days of the statute's enactment).

5. Limit on "Mini Public Offerings" Raised

What You Should Be Thinking About Now:
If you have an established private company (that is not a startup) looking to raise capital, consider the pros and cons of the new Regulation A provisions verses a Regulation D offering. Regulation A offerings are more time-consuming and require more disclosures, but they also do not have any limitations on the number or type of investor and the securities may be traded freely immediately after purchase. Because the securities are not restricted, securities purchased through a Regulation A offering may be more appealing to institutional investors.

Before:
Regulation A provides an exemption from registration for public offerings of up to $5 million in any 12 month period, without any restrictions on the types of investors that can participate in the offering. A Regulation A offering is often characterized as a "mini-public offering" because the process is similar to a public offering, but without some of the reporting and disclosure obligations required for an IPO. Regulation A is rarely used today, however, because the offering threshold has not been adequately increased over the last two decades to reflect the rising costs associated with bringing a small company public and the offering is not exempt from State Blue Sky Laws.

After:
The JOBS Act significantly increases the offering threshold from $5 million to $50 million, which must be reviewed by the SEC every two years. It also creates additional protection for investors by requiring audited financial statements to be included in the offering circular, and the SEC may require periodic disclosures regarding the issuer's financials, business operations, or other matters to be filed and provided to investors.

Effective: Unknown (there is no deadline for the SEC's rulemaking).

6. Conclusion

The JOBS Act loosens many restrictions that small businesses faced when raising funds, but in exchange more disclosures will be required. In light of the SEC's significant concerns about investor fraud, companies should carefully weigh the advantages and disadvantages of taking advantage of these new provisions and make sure that their financial documents, disclosures, and other company information are complete and accurate.