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The Jobs Act: Improving Access to Capital Markets for Emerging Growth Companies

On April 5, 2012, the Jumpstart Our Business Startups Act or “Jobs Act” was signed into law by President Obama with the stated purpose of increasing American job creation and economic growth by improving access to the public capital markets for emerging growth companies. Specifically, the Jobs Act:

- creates a new category of “emerging growth company” under the securities laws and reduces certain financial reporting and disclosure obligations on these companies for up to 5 years after their initial public offering;
- directs the Securities and Exchange Commission to eliminate the prohibition on general solicitations for private offerings under Rule 506 of Regulation D and resales under Rule 144A;
- legalizes crowdfunding through brokers and “funding portals”;
- authorizes the SEC to increase the maximum amount permitted to be raised in a Regulation A offering from \$5 million to \$50 million in any 12-month period; and
- increases the number of shareholders of record that a company may have before it becomes obligated to file SEC reports.

Creation of the ‘Emerging Growth Company’ Designation

The Jobs Act creates the “emerging growth company” as a new category of issuer under both the Securities Act and the Securities Exchange Act.

Definition of “Emerging Growth Company”

An “emerging growth company” is an issuer that had total annual gross revenues of less than \$1 billion during its most recently completed fiscal year. The issuer would continue to be an “emerging growth company” until the earlier of:

- the last day of the fiscal year during which it had total annual gross revenues of \$1 billion or more;
- the last day of the fiscal year of the issuer following the fifth anniversary of its initial public offering;
- the date on which the issuer has, during the previous 3-year period, issued more than \$1 billion in non-convertible debt; and
- the date on which it is deemed a “large accelerated filer.”

Notwithstanding the foregoing, an issuer that consummated an IPO on or prior to December 8, 2011 will not be eligible to be deemed an emerging growth company. The relief provided to emerging growth companies is available immediately.

Benefits for Emerging Growth Companies

Emerging growth companies will have more lenient disclosure and compliance obligations with respect to executive compensation, financial disclosures and certain new accounting rules. Specifically, an emerging growth company will not be required to:

- comply with “say on pay” proposals or pay versus performance disclosures;
- include more than two years of financial statements in the registration statement for its IPO;
- include selected financial data for any period prior to the earliest audited period presented in connection with its IPO; or
- comply with new or revised accounting standards that are only applicable to public reporting companies.

In addition, emerging growth companies will be exempt from the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act, or SOX, and be given a longer transition period for compliance with new audit standards. Further, SOX has been amended to provide that any rules of the Public Company Accounting Oversight Board, or PCAOB, requiring mandatory audit firm rotation or auditor discussion and analysis will not apply to an emerging growth company. In addition, any future rules adopted by the PCAOB would not apply to audits of emerging growth companies unless the SEC determines otherwise.

The Jobs Act provides that emerging growth companies may start the IPO process by confidentially submitting draft registration statements to the SEC for nonpublic review. Confidentially submitted registration statements would need to be publicly available at least 21 days prior to beginning the road show for the IPO. Emerging growth companies would also be free to “test the waters” with qualified institutional buyers and institutional accredited investors before and during the registration process.

Analyst Reports for Initial Public Offerings of Emerging Growth Companies

The Jobs Act removes some of the restrictions on investment banks underwriting public offerings while simultaneously providing analyst research reports on a particular issuer that was designated as an “emerging growth company.”

Elimination of Prohibition on General Solicitation For Accredited Investors and Qualified Institutional Buyers

The Jobs Act directs the SEC to revise its rules to:

- provide that the prohibition against general solicitation or general advertising will not apply to offers and sales of securities made pursuant to Rule 506, provided all purchasers of the securities are accredited investors, and
- provide that the prohibition against general solicitation or general advertising will not apply to offers and sales made under Rule 144A, provided that the seller reasonably believes that all purchasers of the securities are qualified institutional buyers.

It is currently unclear whether these exemptions will apply to offerings exempt from registration under Section 4(2) of the Securities Act to the extent they do not satisfy all of the conditions of Rule 506. The SEC has 90 days from the date of enactment of the Jobs Act to promulgate rules to effect elimination of the specified prohibitions on general solicitation and general advertising.

Creation of a 'Crowdfunding' Exemption

Crowdfunding refers to the recent (often internet facilitated) technique of seeking financing for a business through small investments from a relatively large pool of individual investors. Under current securities laws, crowdfunding raises a number of problematic registration exemption issues. The Jobs Act attempts to remedy this by creating a new crowdfunding exemption from the registration requirements of the Securities Act for transactions involving the issuance of securities through a broker or SEC-registered "funding portal," for which:

- the aggregate amount of securities sold in the previous 12 months to all investors by the issuer is not more than \$1 million; and
- individual investments by any investor in the securities during any 12-month period are 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.

Such securities would be considered restricted securities subject to a one-year holding period, with certain exceptions, such as sales to accredited investors or family members. The Jobs Act also provides express securities fraud remedies against the issuer of securities sold under the crowdfunding exemption, which includes extending liability to directors, partners and certain senior officers of the issuer.

Disclosure Requirements

The issuer must file with the SEC, provide to the broker or funding portal, and make available to potential investors at least 21 days prior to the first sale, certain information about the issuer. This information is similar to what many companies currently use in offering memoranda in private offerings and includes:

- the name, legal status, physical address and website of the issuer;
- the names of officers, directors and greater than 20% shareholders;
- a description of the issuer's current and anticipated business;
- a description of the financial condition of the issuer, including, for offerings where the aggregate amounts sold under the crowdfunding exemption are:
 - \$100,000 or less, income tax returns for the most recently completed fiscal year and financial statements, certified by the principal executive officer of the issuer;
 - more than \$100,000, but less than \$500,000, financial statements reviewed by an independent public accountant; or
 - more than \$500,000, audited financial statements;
- a description of the intended use of proceeds;
- the target offering amount and the deadline to raise such amount;
- the price to the public of the securities, or method to determine the price;
- a description of the ownership and capital structure of the issuer, including the terms of the offered security and each other security of the issuer and how such terms may be modified, limited, diluted or qualified;
- risks to purchasers of minority ownership and corporate actions, including issuances of shares, sales of the issuer or its assets or transactions with related parties; and
- such other information as the SEC may prescribe.

The issuer must also annually file with the SEC and provide to investors its results of operations and financial statements.

'Blue Sky' Pre-emption

Securities sold pursuant to the crowdfunding exemption are "covered securities" for purposes of the National Securities Markets Improvement Act, or NSMIA, and, therefore, are exempt from state securities registration requirements, or "Blue Sky," laws. This preemption does not prohibit state enforcement actions based on alleged fraud, deceit, or unlawful conduct.

Creation of 'Funding Portals'

A person acting as an intermediary in an offer or sale of securities under this new crowdfunding exemption will have to register with the SEC as a broker or funding portal and will also need to register with any applicable self-regulatory organizations. Such intermediary will also have to comply with a number of requirements designed to ensure that investors are informed of the possible risks associated with a new venture, including conducting background checks on each officer, director and greater than 20% shareholders of the issuer. Additionally, the Jobs Act instructs the SEC to promulgate rules or regulations under which an issuer, broker or funding portal would not be eligible, based on its disciplinary history, to utilize the exemption.

SEC Rulemaking

The SEC is directed to issue rules as may be necessary or appropriate for the protection of investors to implement the crowdfunding exemption within 270 days after the enactment of the Jobs Act. In addition, the dollar amounts are to be indexed for inflation at least every five years for changes in the consumer price index.

Raising the Regulation A Limit to \$50 million

The Jobs Act amends Section 3(b) of the Securities Act to direct the SEC to amend Regulation A so as to increase the aggregate offering amount that may be offered and sold within the prior 12-month period in reliance on Regulation A from \$5 million to \$50 million. The SEC is required to review the limit every two years and to increase the amount as it determines appropriate or explain to Congress its reasons for not increasing the limit on Regulation A offerings.

No 'Blue Sky' Pre-emption

Predecessor bills would have made the Regulation A exemption more appealing by making Regulation A offered securities exempt from "Blue Sky" laws. Although the Jobs Act does not provide that securities offered under Regulation A are explicitly exempt, it does have a provision requiring the Comptroller General to conduct a study on the impact of Blue Sky laws on offerings made under Regulation A. Securities offered and sold to "qualified purchasers," to be defined under NSMIA, or on a national securities exchange would be "covered securities" and exempt from Blue Sky laws.

Modifying Registration Thresholds

Currently, Section 12(g) of the Exchange Act requires an issuer with assets in excess of \$1 million and a class of security held by more than 500 shareholders of record to register such security with the SEC and, therefore, become subject to the reporting requirements of the Exchange Act. The Jobs Act amends the registration thresholds to require registration only when an issuer has:

- either 2,000 or more shareholders of record, or 500 shareholders of record who are not accredited investors, and
- assets in excess of \$10 million.

Exceptions to "Held of Record" Definition

Further, the Jobs Act amends the definition of "held of record" to exclude securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of the Securities Act. It also directs the SEC to adopt rules providing that securities acquired under the crowdfunding exemption are similarly excluded.

Increased Thresholds for Community Banks

The Jobs Act amends Section 12(g) of the Exchange Act by increasing the shareholder registration threshold in the case of an issuer that is a bank or a bank holding company to 2,000 persons. The bill also makes it easier for banks and bank holding companies to deregister and cease public company compliance requirements by increasing the threshold for deregistration for those entities from 300 persons to 1,200 persons.

Implementation of the Jobs Act

SEC Rulemaking and Studies

The Jobs Act directs the SEC to adopt rules implementing certain provisions of the act as well as to conduct a number of studies and report back to Congress.

SEC Concerns

A number of SEC Commissioners, including Chairman Mary Schapiro, have publicly expressed concerns on the balance between enhancing capital formation and the reduction in investor protections. The Jobs Act does not affect Rule 10b-5 of the Securities Act and adds some additional securities fraud remedies, so issuers should continue to be scrupulous about compliance with their disclosure obligations.

Full Text of the Jobs Act

The Jobs Act was enacted on April 5, 2012. The text of the act is currently available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

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