With the signing of the Jobs Act 2012 (jumpstart our business startups), it just got easier for smaller companies to raise money – and financial institutions to get into trouble.

WHAT THE LAW MEANS FOR SMALL BUSINESSES, FINANCIAL INSTITUTIONS AND INSURERS

Recent studies have shown a substantial decrease in the number of IPOs and in start-up capital formation in recent years, both home-grown and from abroad. While acknowledging that the financial crisis has naturally influenced capital-raising demand, authorities blame the inhospitable environment for the decline in corporate issues. Some of the major hurdles facing small corporations are:

- The cost of Sarbanes-Oxley compliance
- The lack of research coverage
- Lower trading profits for intermediaries resulting from changes in the marketplace

At a time when unemployment continues to hover near record numbers, the Administration and Congress recognize the urgency in helping to get start-ups (frequently the driver of economic growth) back on track.

WHAT THE JOBS ACT AIMS TO DO

The Act attempts to address these hurdles with three dramatic changes, taking a couple of steps back in terms of compliance to relieve smaller corporations of compliance burdens when seeking to raise equity.

As startling as the changes themselves, is the breadth of the companies affected by the new regulation. The Wall Street Journal calculates that fully 97% of companies in the United States were transfigured by the Act, from run-of-the-mill corporations to “Emerging Growth Companies” or EGC. In fact, the law designates every business earning less than $1 billion in revenue per year an EGC. That means that in 2011, over 90% of America’s 107 IPOs would have qualified for relief under the new JOBS Act.

What are the three revisions to the fund-raising process?

1. Reduction in disclosure requirements
2. Removal of restrictions on analyst coverage by underwriters
3. Introduction of a new “crowd-funding” process that will allow start-ups to attract small investors through online sites and social media

These changes unwind some of the requirements imposed as a result of the Sarbanes-Oxley Act. That decade-old Act was instituted as a result of the fraud surrounding such infamous cases as Enron and WorldCom. Some critics of the new JOBS Act suggest that, by removing the restraints, we may be inviting fraud back into our fund-raising process.
REDUCED DISCLOSURE REQUIREMENTS FOR IPOS

The JOBS Act was designed to facilitate raising capital by reducing regulatory burdens. Specifically, the Act creates a separate class of issuers under the U.S. Securities Act of 1933 and the Exchange Act of 1934 for “emerging growth companies.” Emerging growth companies, you will recall, were defined as issuers with annual gross revenues of under $1 billion and a public float of under $700 million.

These companies, when going public, are now exempt from some of what have been viewed as the more onerous accounting and disclosure requirements previously applicable to all public companies. This was done by amending the Securities Act, the Exchange Act, and Sarbanes-Oxley to provide for reduced reporting requirements (1) in Initial Public Offering (IPO) registration statements and (2) for a period of up to five years after an emerging growth company’s IPO.

WHICH RULES ARE RELAXED

Emerging growth companies will now be:

- Permitted to communicate with accredited investors and qualified institutional buyers in advance of potential IPOs, as well as follow-on, secondary public offerings
- Able to involve research analysts more freely in the IPO process by permitting research to be published during the period immediately following the IPO
- Able to file an IPO registration statement with the SEC on a confidential basis, provided that the registration statement is filed publicly within 21 days of the commencement of the road show
- Exempt from auditor attestation on internal control assessments under Sarbanes-Oxley Section 404(b)
- Exempt from certain compensation disclosure requirements along with Dodd-Frank Act’s “say-on-pay” shareholder voting

Other benefits for emerging growth companies going public will include relaxed financial disclosure, accounting and auditing requirements, such as:

- Needing to disclose only two years of audited financial statements (rather than three)
- No mandatory disclosure of selected financial data for periods before those periods presented in its financial statements
- A grace period with respect to certain new or revised financial standards
- An exemption from Public Company Accounting Oversight Board rules adopted after the date of enactment of the JOBS Act

SPEEDING THE PATH TO IPOS

By significantly reducing the costs of emerging growth companies going public (and later complying with public company rules and regulations), with the ability to file a registration statement on a confidential basis while enhancing flexibility in communicating with potential investors prior to an IPO, smaller companies are being encouraged to “test the waters” without disclosing confidential information or suffering adverse publicity should their IPOs be cancelled or delayed. This means that the JOBS Act may stimulate emerging growth companies to go public sooner in order to take advantage of the other benefits of being a public company, i.e., investor and employee liquidity, the availability of capital for acquisitions, and favorable publicity.
LIABILITY RULES NOT RELAXED

Note, however, that there has been no direct relaxation of any of the liability rules for public companies. So, for example, if a weakness in internal controls were to rear its ugly head after an emerging growth company went public, the new exemption from an auditor’s attestation as to these controls would not limit or eliminate the resulting exposure for the company’s directors or officers.

NEXT STEPS

The JOBS Act requires the SEC to adopt implementing rules on these changes to Regulation D within 90 days of its passage – that is, by July 5. The Act also raises the threshold for registration under the Exchange Act.² The JOBS Act amends Section 12(g) of the Exchange Act to increase the limit on shareholders of record from 500 to 2,000 or, in the alternative, 500 persons who are not:

1. “Accredited investors”
2. Employees of the issuer who received shares pursuant to an employee compensation plan
3. Investors who received shares under the crowdfunding exemption of the JOBS Act

Among the topics that the SEC must address in its rulemaking is what steps an issuer must take to verify “accredited investor” status.

UNDERWRITER ANALYST COVERAGE NOW ALLOWED

The new law essentially unwinds the rules affecting analysts enacted in July 2002 as part of the Sarbanes-Oxley Act – at least as they relate to the newly defined emerging growth companies. Prior to 2002 small companies planning IPOs were often only followed by the broker or investment bank planning on leading their IPO. Potential conflicts would arise when analysts at a firm were predisposed to give IPO prospects favorable ratings, despite negative financials, in hopes of winning more business from the newly public company.

Small firms seeking to do IPOs are frequently not of sufficient size or profit potential for investment bank analysts to cover the fledgling public companies. So for the past decade (since Sarbanes-Oxley) these emerging growth companies have had a difficult time getting investment bank analysts to cover and publish their analysis. Supporters of the JOBS Act felt that investors were reluctant to invest in a firm that had no analyst coverage and that the need to encourage IPO investors overcame any potential risk of a conflict of interest.

The JOBS Act therefore amends the definition of “sale” in Sec. 2(a)(3) of the Securities Act so that an analyst report will no longer qualify as an offer to sell. The portion of the Securities Exchange Act amended by Sarbanes-Oxley (Sec 15D) is adjusted to once again allow securities analysts to call on companies (emerging growth companies at least), with investment bankers, a practice that had been banned for the past decade. The ban on publishing and releasing reports on companies that have an underwriting relationship is also lifted with a revision of Section 15A of the Securities Exchange Act.

INTRODUCING CONFLICTS OF INTEREST?

The change is not inconsequential. Last year over 90% of the companies launching IPOs qualified as emerging growth companies. Underwriters of those companies may once again issue research and recommendation on the qualifying companies they are underwriting.

Opponents to the new legislation fear that unwinding this particular piece of Sarbanes Oxley legislation will open the floodgates on the type of conflicts of interests that occurred at the end of the internet bubble and lead analysts to issue buy recommendations on stocks that are clearly overvalued.

While banks and brokers are once again free to issue analyst reports on client-companies with less than a billion dollars in revenue, they are still bound by all other securities regulations and will be liable if they publish fraudulent statements about stocks in general.

WHAT NEXT?

What remains to be seen is how long securities underwriters will take before they are once again offering to cover customers and prospective customers.

While not required by the current law, prudent financial institutions will develop clear internal guidelines for when and how underwriting teams and research teams interact.
HOW START-UPS CAN ATTRACT SMALL INVESTORS ONLINE WITHOUT BEING UNFRIENDED BY THE SEC

A primary goal of the JOBS Act was to facilitate raising capital by reducing regulatory burdens for organizations. One avenue through which it attempts to do this is by easing the rules relating to crowdfunding.

Crowdfunding itself has been around for some time and is used for a wide variety of purposes: from disaster relief and political campaigns to funding a movie or a start-up business. In fact, last year, crowdfunding raised nearly US$1.5 billion.

WHAT’S CROWDFUNDING?

crowdfunding (crowd|fund|ing) noun
...the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet: musicians, filmmakers, and artists have successfully raised funds and fostered awareness through crowdfunding...

(Oxford Dictionaries)

The JOBS Act will now permit funds to be raised from a wider pool of smaller investors with fewer restrictions. The Act accomplishes this by modifying the Securities Act of 1933 for initial public offerings. It adds an exemption for transactions that don’t exceed $1 million over a 12-month period and are conducted through a broker or funding portal that complies with the certain requirements (discussed below). Depending on each investor’s financial wherewithal, these transactions cannot exceed:

- Investors with < $100,000 annual income or net worth: the greater of $2,000 or 5% of the investor's annual income or net worth

- Investors with ≥$100,000 annual income or net worth: 10% of the investor's annual income or net worth, not to exceed a maximum aggregate amount sold of $100,000
NOT JUST ANY PORTAL IN A STORM
Crowdfunding has to be done through a broker or funding portal complying with the requirements of Section 4A(a). These require portals to:

- Register with the SEC and an applicable self-regulating organization (which may be FINRA)
- Provide any disclosure required by the SEC (to be determined)
- Ensure that each investor reviews education information, confirm that the investor understands the risk of loss of its investment and can bear such loss, and answer questions demonstrating that the investor understands the risks inherent in investing in startup companies (as well as other matters that the SEC may require)
- Take measures to reduce the risk of fraud
- Make certain that the issuer may only receive the offering proceeds after the aggregate capital raised exceeds the targeted offering amount, as well as permit all investors to cancel their commitment to invest
- Make sure that no investor exceeds the per-investor limits in any 12-month period
- Prohibit its directors, officers or partners from having any financial interest in any company that uses the broker or funding portal
- Not compensate promoters, finders or lead generators
- No later than 21 days before the first sale to investors, make available to the SEC and potential investors any disclosure information provided by the issuer to meet the requirements of Section 4A(b)

QUESTIONS OF DISCLOSURE AND CONTROL
Clearly there are a lot of unknowns about how the new crowdfunding rules will work. The SEC, for example, could potentially make crowdfunding very costly through the portals. And while a JOBS Act goal is to facilitate the raising of capital, crowdfunding actually requires more disclosure than private offerings conducted under Regulation D's safe harbors. Until we see the SEC’s rules, the future of crowdfunding will remain uncertain.

With crowdfunding, a company's shareholders could potentially go from just friends and family to a few thousand overnight. This raises the issue of corporate control as well as how venture capitalists and other major investment firms might view an already crowded organization when it comes time to raising additional capital.

STATE LAWS HAVEN’T CHANGED
While state securities law is preempted by the JOBS Act, state law is not. Companies will still need to comply with state corporation law. Each state’s code is different, with some imposing greater costs than others.
DIRECTORS AND OFFICERS BEWARE

Big and bad: the JOBS Act defines “issuer” unusually broadly to include the issuing company’s directors and officers. This means that if material misstatements were made during an offering, disgruntled investors could go after the directors and officers personally. This provision could mean that very few directors or officers may be willing to come on board and incur personal liability. Most D&O Liability insurers are taking a wait-and-see attitude, but some are expressing concern about pump-and-dump schemes.

This new freedom rings in once the Securities and Exchange Commission (SEC) issues its new rules on crowdfunding. The Commission has 270 days from the enactment date (April 5, 2012) to lay down these rules.

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1 http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf
2 Within Regulation D, most issuers use the Rule 504 exemption for private offerings of up to $1 million, and the Rule 506 exemption for all other offerings. However, Reg D private offerings can’t use any general solicitation or advertisement. And all securities sold under Reg D are “restricted” securities, so the investor is restricted in its resale.
3 See: TITLE III—CROWDFUNDING. These JOBS Act provisions have the exhaustive but potentially illuminating title of: ‘Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012’ or the ‘CROWDFUND Act’.