The Jumpstart Our Business Startups Act: General Solicitation, Crowd Funding, and Decreased Securities Regulation for Emerging Growth Companies

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On March 27, 2012, the U.S. House of Representatives passed, and forwarded to the President for signature, the "Jumpstart Our Business Startups Act" (the "*JOBS Act*"). President Obama has indicated that he will sign the JOBS Act at a formal ceremony next week. The JOBS Act contains significant revisions to U.S. securities laws that may fundamentally change the manner in which start-ups and emerging companies approach capital formation. These revisions eliminate the long-standing prohibition on general solicitation or advertising for "private" placements to accredited investors, exempt "crowd funding" from the registration requirements under the Securities Act of 1933 (the "*1933 Act*"), and decrease the disclosure and reporting obligations of "emerging growth companies" both during, and after, an initial public offering.

"Private" Capital Formation

General Solicitation and Rule 506

Although most of the publicity surrounding the JOBS Act has focused on the crowd-funding provisions contained in Title III, the most important provision of the Act may lie in Title II: the elimination of the prohibition on general solicitation and advertising in offerings to accredited investors that are exempt from registration under Rule 506 of Regulation D under the 1933 Act. Because of the absence of dollar limitations on offerings made under Rule 506 and the preemption of state regulation afforded such offerings, the vast majority of "private placements" conducted today are specifically designed to comply with Rule 506. And because no specific form of disclosure is required to qualify for the exemption in an offering made solely to accredited investors, most Rule 506 private placements are designed for sale solely to accredited investors.

Under Title II of the JOBS Act, the SEC is charged with revising its regulations within 90 days after the JOBS Act is signed to provide that the prohibition against "general solicitation and general advertising" contained in Rule 502(c) of Regulation D will not apply to Rule 506 offerings in which all purchasers are accredited investors. Subject to relevant antifraud provisions and to the SEC's new rules, this change would conceivably allow any company, including not only start-ups, venture capital, and private equity firms, but also more established companies and public reporting companies, to communicate and provide notice of accredited-only Rule 506 offerings on websites, through print, televised or social media, or through third-party websites that provide a platform to offer and sell Rule 506 offerings..

In fact, Title II of the JOBS Act specifically exempts from the broker-dealer registration requirements of Section 15(a)(1) of the Securities Exchange Act of

1934 (the "*1934 Act*"), third parties that operate websites or other platforms that facilitate the offer, sale, negotiation, or advertisement of Rule 506 transactions, or that provide "ancillary services" such as due diligence or standardized documentation. This exemption is conditioned only upon the third party (1) receiving no compensation in connection with the purchase or sale of the security, (2) not holding investor funds or securities in connection with the transaction, and (3) not being subject to statutory disqualifications based on prior bad acts.

Once the SEC's rules eliminating the prohibition on general solicitation are in place, it is likely that we will see an entirely new practice of broadly disseminated offerings of various sizes to accredited investors, through the Internet and other media, as well as new service providers that facilitate this new form of quasi-public offering.

Crowd Funding

Title III of the JOBS Act creates new Section 4(6) of the 1933 Act: an exemption from registration under the 1933 Act for offers and sales of securities through crowd-funding. Section 4(6) will exempt the offer and sale of securities by a domestic, non-reporting issuer to an unlimited number of purchasers, regardless of whether accredited, through a broker-dealer or "funding portal," as long as:

- the aggregate dollar amount of securities sold in the offering, together with all securities sold in reliance on the exemption in the previous 12 months, is not more than $1,000,000;
- the aggregate dollar amount of securities purchased by any single investor in the offering, and in all other offerings under the new exemption (whether or not by the same issuer) in the previous 12 months, is not more than (1) the greater of $2,000 or 5 percent of the annual income or net worth of the investor if such annual income or net worth is less than $100,000; and (2) 10 percent of the annual income or net worth of the investor (but not more than $100,000) if such annual income or net worth is equal to or greater than $100,000;
- the offer and sale of the securities is not conducted directly by the issuer but instead through an intermediary: a registered broker-dealer or registered funding portal (as defined in Section 304 of the JOBS Act) that complies with specific disclosure and investigation mandates set forth in a new Section 4A (a) of the 1933 Act; and
- the issuer files with the SEC, and provides to the broker and funding portal, and to each investor, disclosure that parallels disclosure required by Rule 502 of Regulation D for sales to non-accredited investors in private placements, as well as annually files operating information with the SEC, all as specified in new Section 4A(b) of the 1933 Act.

Issuer disclosure. In an effort to counter criticism that the new crowd-funding exemption would void the protections of federal securities laws, the U.S. Senate amended the original House version of the JOBS Act to require significant disclosures from the issuer. This information must be filed with the SEC and disclosed to the investing public through the intermediary. In addition to the identity of the issuer and its officers, directors and significant shareholders, new Section 4A(b) of the 1933 Act will require the issuer to describe its business and business plan; the intended use of the offering proceeds; the offering price, method of determining the offering price, targeted offering amount and deadline for achieving the targeted offering amount; the terms of the securities offered and the impact of other securities and rights (e.g, options) to acquire securities; and the risks of the

investment, including risks created by minority ownership and the capital structure of the issuer. Importantly, the issuer will also be required to include:

- for offerings of $100,000 or less, the issuer's income tax return for the last year and financial statements certified by the principal executive officer;
- for offerings of more than $100,000 but not more than $500,000, financial statements that have been reviewed by an independent certified public accountant; and
- for offerings of more than $500,000, audited financial statements.

The issuer will be prohibited from advertising the offering except through the intermediary, and from compensating anyone for promoting the offering unless the compensation is disclosed in accordance with rules to be adopted by the SEC. Importantly, the issuer will apparently also be required to file annual reports of its operating results and financial condition with the SEC, and forward those reports to crowd-funding investors in accordance with rules to be adopted by the SEC.

Using intermediaries. The JOBS Act makes clear that third-party websites will play a critical role in facilitating crowd funding. A number of websites have already been formed to provide a platform where individual issuers will announce the terms of their crowd round and individual investors will be able to review information that the issuer has provided and decide whether to invest. These intermediaries will be required under new Section 4A to register with the SEC and FINRA as a broker or a funding portal. The SEC is obligated to issue rules exempting funding portals from the broker-dealer registration requirements, and establishing separate registration for portals, within 270 days after the JOBS Act is signed. Unlike registered broker-dealers, registered funding portals will be prohibited from offering investment advice, actively soliciting purchases, sales or offers to buy securities, compensating employees or agents on the basis of the securities sold, or holding investor funds or securities.

To function as an intermediary in a crowd funding under new Section 4A(a) of the 1933 Act, a broker or funding portal must, among other things:

- provide to investors disclosures that the SEC, by rule, requires, including educational materials and disclosures of risks, and ensure that each investor affirms understanding of the risks of the investment;
- take reasonable measures to reduce the risk of fraud including conducting background checks of the issuer's officers, directors and significant shareholders; and
- make the information provided by the issuer described above available to investors and the SEC at least 21 days prior to the first sale.

Brokers and funding portals will be prohibited from compensating promoters, finders, or lead generators, and from having any interest, directly or through their directors, officers or partners, in the issuer.

Restrictions on transfer. Securities purchased in a Section 4(6) transaction will not be transferable for one year after purchase, unless the securities are transferred (1) to the issuer, (2) to an accredited investor, (3) pursuant to registration, or (4) to a member of the investor's family or upon the investor's death, divorce or other events specified by the SEC.

State preemption and fraud liability. In addition to the exemption from registration

under the 1933 Act, the JOBS Act provides that securities sold in compliance with Section 4(6) will be “covered securities” under Section 18(b) of the 1933 Act and therefore exempt from state law registration or qualification provisions (although not state law antifraud and broker-dealer enforcement laws, which are specifically preserved under the JOBS Act). Unlike covered securities under the Section 4(2) exemption, no state filing or filing fee will be required to obtain federal preemption for an offering exempt under Section 4(6).

The JOBS Act also makes clear that Section 4(6) is an exemption, not an exclusion from federal securities antifraud law and regulations. The Act specifically creates a private right of action by any purchaser under Section 12(a)(2) of the 1933 Act against the issuer, the issuer’s directors and executive officers (including controller) and “any person who offers and sells the security in such offering.”

Next steps. The JOBS Act requires the SEC, within 270 days after signing, to adopt regulations implementing the crowd-funding provisions, including regulations detailing issuer disclosure and reporting obligations, creating a new system of regulation and registration for funding portals, and importing “bad boy” provisions that prohibit certain issuers and associated persons from participating in crowd fundings, and generally implementing the requirements of the JOBS Act.

The new crowd-funding exemption in Section 4(6) constitutes a significant re-calibration of the balance in U.S. federal securities laws between encouraging capital formation in small offerings and protecting small investors. The practical impact of the new exemption will depend greatly on the SEC’s implementation of the crowd-funding disclosure requirements and the other restrictions outlined in the new statutory exemption. Many questions remain. SEC Rule 504 has long provided an exemption from 1933 Act registration for offerings not exceeding $1 million to an unlimited number of purchasers. Rule 504 offerings, however, generally require registration under relevant state securities laws if made through general solicitation. The SEC’s crowd-funding rules will also determine whether eligible issuers will find the cost of compliance with the requirements of the new exemption worth the benefit of being freed from state registration requirements.

Section 3(b) and Regulation A

Regulation A, an exemption from registration adopted by the SEC under Section 3(b) of the 1933 Act, once facilitated small public offerings, but has become an unused backwater of securities practice because of the $5 million offering size limitation imposed by Section 3(b). In Title IV of the JOBS Act, Congress seeks to address this limitation by adding a new Section 3(b)(2) to the 1933 Act. Section 3 (b)(2) provides statutory authority for an exemption for public offerings of equity, debt or convertible securities of up to $50 million during any 12 months. Clearly designed to encourage a newly revised Regulation A, Title IV specifically provides that the securities issued will not be restricted securities, and requires the SEC to adopt regulations allowing use of offering statements prior to filing, requiring the filing of periodic disclosures (including annual audited financial statements), and facilitating electronic filing. Unfortunately, Title IV provides that securities exempt from registration under the 1933 Act because of the Section 3(b)(2) exemption will be exempt from state securities registration requirements under Section 18 of the 1933 Act only if they are offered or sold “on a national securities exchange” or “to a qualified purchaser.” Instead of preempting state regulation as it did with the crowd-funding exemption, Congress directed the Comptroller General to conduct a study of the impact of state securities law on Regulation A offerings for further consideration within three months after the JOBS Act is signed.

Public Reporting: Amendments to Section 12(g) of the 1934 Act

Currently, any company with more than $10 million of assets and 500 or more holders of record of any class of equity securities is required to register such securities under Section 12(g) of the 1934 Act and become subject to the public reporting requirements of Section 13 of the 1934 Act. Section 303 and Title V of the JOBS Act make three significant changes to Section 12(g):

- **2,000 shareholders -** A company will be required to register its securities under Section 12(g) only if it has assets in excess of $10 million and a class of equity securities held of record by 2,000 or more persons, or 500 or more persons who are not accredited investors, as of the end of any fiscal year;
- **Employee compensation plans not counted -** Securities held by employees who acquired them under an employee compensation plan are not considered "held of record" for purposes of computing the registration requirement; and
- **Crowd funding not counted -** Securities acquired pursuant to an offering exempt under Section 4(6) are to be exempted from the Section 12(g) provisions.

Congress left to the SEC the chore of adopting regulations, within 270 days after the JOBS Act is signed, defining how an issuer polices its record holders (and whether it will be required to look beyond the record holders for whom depositories hold securities) to determine whether they are accredited, the extent of the exemption for securities issued in crowd-funding transactions, and the status of securities acquired in secondary transactions from an employee who in turn acquired them under a benefit plan.

Public Capital Formation: "Emerging Growth Companies" and Initial Public Offerings

In response to concerns regarding the impediments to capital raising caused by the public offering and reporting process, Title I of the JOBS Act includes a number of provisions intended to reduce these impediments for, and the costs incurred by, "emerging growth companies." For this purpose, an emerging growth company is defined broadly to include any company with total annual gross revenues of less than $1 billion during its most recently completed fiscal year, but to exclude current public companies that sold common equity securities pursuant to an effective registration statement prior to December 8, 2011. If a company qualifies as an emerging growth company, it remains an emerging growth company until (1) it has $1 billion or more of gross revenue in any fiscal year, (2) the last day of the fifth year after its initial public offering, (3) the date on which it becomes a "large accelerated filer" under the 1934 Act, or (4) it has issued more than $1 billion of nonconvertible debt during any three-year period.

Title I of the JOBS Act attempts to alleviate the regulatory burden on emerging growth companies by:

- reducing the period for which audited financial statements are required in registration statements and periodic reports to two years (from three), and reducing the period for which selected financial information must be provided to the same period (from five years to two years);
- exempting emerging growth companies from the "say on pay," "say on when," "golden parachute approval," and "pay versus performance" requirements for proxy statements under Section 14A(e) and Section 14(i) of the 1934 Act;
- exempting emerging growth companies from the Sarbanes-Oxley Section 404

(b) requirement to obtain an annual auditor's attestation report on internal control over financial reporting (although not management's report on internal control over financial reporting);

- exempting emerging growth companies from any auditor rotation and auditor discussion and analysis requirements adopted by the Public Company Accounting Oversight Board, or other rules that may be subsequently adopted, unless the SEC determines otherwise; and
- allowing emerging growth companies to avoid compliance with accounting pronouncements that apply only to reporting companies (provided that the emerging growth company does not opt to comply with any of such pronouncements).

In addition, the JOBS Act provides specific assistance to emerging growth companies in the offering process by:

- allowing a broker or dealer (regardless of whether participating in the offering) to publish research reports about an emerging growth company that is conducting a public offering (whether before or after the registration statement has been filed or become effective), and relaxing rules to allow analysts, other broker-dealer representatives and management of issuers to communicate together with investors;
- allowing an emerging growth company to inquire about the interest in investing of a qualified institutional buyer or an institution that is an accredited investor prior to the filing of a registration statement; and
- allowing an emerging growth company to confidentially submit to the SEC a draft registration statement for confidential nonpublic review by the staff, provided that the initial confidential submission is publicly filed at least 21 days before the date on which the issuer conducts a road show.

In addition to adopting regulations to implement the foregoing provisions, the JOBS Act directs the SEC to conduct a comprehensive review of Regulation S-K (its uniform disclosure regulation), to determine how that regulation may be modernized and simplified, and report to Congress the results of its review within 180 days after the Act is signed.

More to Come

Like Dodd-Frank and Sarbanes-Oxley before it, the JOBS Act imposes a significant burden upon the SEC to adopt regulations that implement the Act within a relatively short period of time. Some of these new rules, such as those implementing the general solicitation provisions for accredited-only Rule 506 offerings, should be relatively straightforward. Others, such as those related to crowd funding, force the SEC to strike a more delicate regulatory balance between protection of investors and capital formation. Although the JOBS Act contains significant changes to the regulation of capital formation by earlier stage companies, its full impact will likely not be felt until those regulations are finalized.