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JOBS Act - On Regulation A, Regulation D and Crowdfunding Provisions

After a comparatively brief debate in Congress, President Obama signed the Jumpstart Our Business Startups Act (JOBS Act) on April 5, 2012. The JOBS Act enjoyed an unusual level of bipartisan support in the hope that the new law's provisions streamlining the initial public offering process for emerging companies, enhancing the private placement market and leveraging the Internet to raise capital for small companies will result in the creation of new jobs. In this alert we consider the three provisions of the JOBS Act dedicated to facilitating nonpublic offerings of securities: Title II, which allows for public solicitation in connection with certain Rule 506 and Rule 144A offerings; Title III, which creates a new private placement exemption for crowdfunding via the Internet; and Title IV, which may breathe new life into the otherwise little-used Regulation A offering exemption.

TITLE II - ACCESS TO CAPITAL FOR JOB CREATORS

Rule 506 of Regulation D is a long-standing and much-used exemption safe harbor from the registration requirements of the Securities Act of 1933 (Securities Act). Through this exemption, issuers can sell unregistered securities to an unlimited number of accredited investors and a limited number of nonaccredited investors. However, prior to the JOBS Act, Rule 502 of Regulation D prohibited the general solicitation or advertisement of securities in Rule 506 offerings. Thus, issuers needed to have some pre-existing relationship with potential purchasers before conducting a private placement. This created a potentially significant limitation on an issuer's ability to find and raise capital in a competitive process.

Title II of the JOBS Act has reversed that limitation to allow for the general solicitation and advertisement of a Rule 506 offering, as long as all ultimate purchasers are accredited investors. Within 90 days following enactment of the law, the Securities and Exchange Commission must revise Rule 506 to provide that Rule 502's limitations on solicitation and advertisement do not apply to Rule 506 transactions involving accredited investors only. This makes the identification of accredited investors especially significant. Prior to the JOBS Act, purchasers have been allowed to self-certify that they qualify as accredited investors. In a departure from this long-approved practice, however, the JOBS Act provides that issuers are now required to take "reasonable steps" to ensure investors purchasing securities through a Rule 506 offering are "accredited investors." It remains unclear what steps the SEC will require from issuers to verify that purchasers under Rule 506 are actually accredited investors. According to the 14 Law Firm Consensus Report released on April 5, 2012, the current version of Rule 506 will remain in effect until the SEC puts forward the new rules.

Many companies take advantage of Rule 506 to issue securities. By removing the ban on general solicitations, these companies do not have to rely solely on existing relationships for funding. A wider audience of investors can be reached via the Internet, seminars and other venues. Additionally, placement agents and finders can also use Rule 506 to advertise securities through a diverse range of mediums. The fact that purchasers must be accredited investors will not significantly change the audience for Rule 506 offerings, because most issuers avoid offerings to nonaccredited investors because of the additional disclosure burdens it creates.

Title II also amends Rule 144A of the Securities Act. Rule 144A is a safe harbor exemption that allows an individual to resell restricted securities to "qualified institutional buyers." Within 90 days following the enactment of the JOBS Act, the SEC must revise Rule 144A to allow offers to nonqualified institutional buyers, including by means of general solicitation or general advertising. Issuers may not use Rule 144A to offer securities, but instead may sell securities to an intermediary who can resell the securities to qualified institutional buyers. However, pursuant to the JOBS Act, a reseller using Rule 144A can sell

these securities only to purchasers the reseller, and any person acting on behalf of the reseller, reasonably believes is a qualified institutional buyer. As with the accredited investor verification, it remains to be seen what standard the SEC will set for issuers to "reasonably believe" a purchaser is a qualified institutional buyer. Moreover, current Rule 144A remains in effect until the SEC provides the new rules.

Finally, under Title II, individuals who conduct Rule 506 offerings via the Internet or other platforms are not required to register as brokers or dealers. Offerings conducted through these platforms may employ general solicitation and general advertising to market the unregistered securities. Further, individuals will not have to register as brokers or dealers simply because they co-invest in the securities or they provide "ancillary services" (such as due diligence services or providing standardized documents) in the offering of these securities. In order to qualify for the exemption from registration as a broker or dealer, the individual maintaining the offering platform must not receive compensation in connection with the purchase and sale of the securities, must not have possession of customer funds or securities, and must not be subject to disqualification under the Securities Exchange Act.

TITLE III - CROWDFUNDING

Title III (crowdfunding) is the most novel provision of the JOBS Act in that it creates an entirely new exemption from registration of securities offerings structured to take advantage of the Internet's capacity for mass communication and social interaction. Nonetheless, it remains to be seen whether crowdfunding will ultimately be a widely used exemption or spur the kind of startup economic activity Congress and the president intended.

The concept of crowdfunding is based on large numbers of investors each investing relatively small amounts in an issuer, to give early stage companies access to capital while minimizing the risk to individual investors. It also extends the tacit promise of making entrepreneurial investing, of the type previously the exclusive realm of venture capital funds and wealthy individuals, available to the vast majority of potential investors who do not qualify as accredited investors. Because many of the details of Title III were left up to the SEC to determine by additional rulemaking within 270 days after passage of the JOBS Act, however, the new exemption will not become effective until the new SEC rules have been adopted.

Securities issued pursuant to the crowdfunding exemption (crowdfund securities) offer a number of advantages to issuers. As in Rule 506 offerings, they are "covered securities" exempt from state registration requirements (but not from enforcement of state anti-fraud laws). In addition, the original holders of crowdfund securities will not be counted toward the shareholder limits under Section 12(g) of the Securities Exchange Act, which can cause issuers to become reporting companies. As an example of the potential effects of SEC rulemaking, however, whether that exclusion will apply to subsequent holders of crowdfund securities is not so clear.

Unlike Rule 506 offerings, in which issuers deal directly with investors, crowdfunding creates an offering structure that interposes an intermediary between the issuer and the investor. The issuer, the intermediary and the investor alike are subject to specific responsibilities and limitations regarding participation in crowdfund offerings.

Ostensibly, crowdfunding issuers can sell up to $1 million in crowdfund securities, but issuers have to announce a specific target amount. However, the magnitude of financial disclosure required is a function of the targeted size of the offering, and may therefore be the crucial determiner of amounts issuers are willing to ask for. All issuers must provide a description of their financial condition and certain financial information. If an issuer is trying to raise $100,000 or less, it need only provide its most recent tax returns or a copy of its financial statements certified as true and complete by its principal executive officer. If an issuer wants to raise more than $100,000 but not more than $500,000, it must provide financial statements reviewed by an independent public accountant. But if an issuer wants to raise $500,000 or more, it needs to provide audited financial statements. That might prove to be the breaking point for a number of issuers who will have to decide whether the cost and effort of audited financials justifies the additional offering amount.

Other information the issuer must provide includes names of officers, directors and 20-percent-or-greater shareholders; a description of its business; and the intended use of proceeds. In addition, issuers must describe their ownership and capital structure, including the rights of existing shareholders, how the offered crowdfund securities were valued, the risks to purchasers of minority ownership and other information the SEC may require in its rulemaking process. Importantly, the issuer itself cannot advertise the terms of the offering other than by providing notices that direct a potential investor to the crowdfund intermediary.

Once the offering is over, the issuer still retains an obligation to file annually with the SEC and provide to investors reports of the results of operations and financial statements in accordance with the rules developed by the SEC. More than any other requirement, it may be this residual reporting obligation that will cause issuers to think twice about the costs of crowdfunding relative to other available exemptions.

Crowdfund intermediaries must be registered with the SEC as either a broker or a "funding portal," a new service provider concept created for the crowdfund exemption. A "funding portal" is exempt from registration as a broker or dealer but is subject to SEC authority; it is not permitted to offer investment advice, solicit purchases or sales of the crowdfund securities offered in its website, compensate employees or others based on sales of crowdfund securities, or hold or manage investor funds.

The intermediary's role is largely that of a conduit. An intermediary is required to make available to the SEC and potential investors the information provided to it by the issuer. However, intermediaries are also required to fulfill a number of affirmative obligations. These include ensuring potential investors review certain investor education information, affirming the possibility of loss of the entire investment and the investor's ability to withstand such a loss, and requiring investors to answer questions demonstrating an understanding about the risks of investing in a startup, the illiquid nature of crowdfund securities and others the SEC may require. An intermediary is also responsible for ensuring no funds are released to the issuer unless the offering target has been achieved.

Limits are placed on the amount of crowdfund securities that can be sold to an investor in any 12-month period based on his/her annual income and net worth. Investors with either annual income or net worth of less than $100,000 can invest the greater of $2,000 and 5 percent of annual income or net worth. Investors with either annual income or net worth of more than $100,000 are allowed to invest up to 10 percent of their annual income or net worth, up to a maximum of $100,000. Annual income and net worth will be calculated in the same manner as for accredited investors under Regulation D. It is not clear whether and to what extent investors will be allowed to self-certify their status, as is currently the case in Rule 506 offerings. Moreover, the crowdfund exemption makes the intermediary responsible for policing whether potential investors are adhering to these limitations in the context of a particular offering.

Crowdfund securities will not be transferable for a year after initial purchase, except to the issuer or an accredited investor and in certain other circumstances. Issuers may want to add additional restrictions. Foreign entities will not be able to use crowdfunding, because it will be available only to entities organized in the United States. Issuers and intermediaries will be subject to disqualification from using crowdfunding for prior bad acts.

The issue of potential fraud was raised early by many legislators and the SEC, and this resulted in the adoption of a more restrictive version of crowdfunding than the one originally proposed by the House of Representatives. In addition to scaling back offering amounts and increasing disclosure requirements, the version of crowdfunding passed into law creates liability for issuers that make untrue statements of material facts or fail to state material facts required to make statements not misleading. For purposes of the anti-fraud provisions of Title III, the concept of "issuer" is broadly defined to include directors and officers or partners of an issuer, who offer or sell crowdfund securities. Investor remedies in such cases include rescission, if they still own the securities, or seeking damages if they do not. Ironically, some state securities authorities have speculated the crowdfunding law passed may not be attractive enough for genuine growth companies to consider and may be more favored by "fraudsters" looking to take advantage of unsophisticated investors looking for the next Google or Facebook.

Whether crowdfunding will be able to achieve the goals of funding more early-stage companies and creating jobs is far from certain. The financial disclosure limits and other obligations on issuers may keep many companies out of the market or keep them from raising amounts that will spur employment. Companies that are able to obtain venture capital financing may continue to use Rule 506 private placements, relegating crowdfunding to the realm of companies that are unable to get the backing of professional investors or to small companies that need infusions of capital but are unlikely to grow much in the future. The rules developed by the SEC may largely determine whether crowdfunding becomes a genuine path to growth for startups or an unfulfilled promise.

TITLE IV - SMALL COMPANY CAPITAL FORMATION

Section 3(b) of the Securities Act gives the SEC authority to exempt certain securities from registration. Pursuant to that provision, the SEC adopted Regulation A to help small companies raise limited amounts of capital without going through full, and potentially burdensome, registration requirements. Thus, a Regulation A offering is often called a "mini-registration" because the issuer needs to provide only certain documentation, such as Form 1-A and financial information. However, Regulation A has been a relatively little-used exemption. Title IV of the JOBS Act is intended to increase the appeal of Regulation A for issuers by adding a new exemption many have referred to as "Regulation A+."

Regulation A+ raises the maximum amount that may be offered from $5 million to $50 million. The SEC will review this offering ceiling every two years to consider increasing the amount that may be issued. Issuers can use Regulation A+ to offer equity securities, debt securities, and debt securities convertible or exchangeable for equity interests (including guarantees of such securities). In addition, Regulation A+ securities may be promoted through general solicitation and advertisement, expanding the potential pool of investors available to issuers. There are no holding periods or similar restrictions on resales of Regulation A+ securities. Issuers using the revised Regulation A+ may also "test the waters" and solicit interest prior to the offering by filing an offering statement. Civil liability through Section 12(a)(2) applies to any person offering or selling securities under Regulation A+.

In a change from previous law, securities offered through Regulation A+ will now be "covered securities" under NSMIA and will not be subject to state securities law review. In order to qualify for this exemption and avoid state securities law review, however, the securities must be sold on a national exchange or be sold to "qualified purchasers." The SEC has not yet provided a definition for "qualified purchaser" under this provision. The JOBS Act also charges the comptroller general with studying the impact of Blue Sky Laws on offerings made under Regulation A.

Finally, issuers offering securities through this Regulation A+ will have to meet certain disclosure requirements. The SEC will require issuers to file audited financial statements on an annual basis. Additionally, Title IV grants the SEC the authority to promulgate other rules and regulations for the protection of investors. Such rules may include a requirement that issuers file with the SEC and distribute to prospective investors an offering statement or other documentation containing audited financial information, a description of business operations and corporate governance principles, and information on the issuer's use of investor funds. The SEC may also require disqualification provisions similar to those regulations found in the Dodd-Frank Wall Street Reform and Consumer Protection Act that currently prohibit felons and other "bad actors" from making Regulation D offerings.