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## The Jumpstart Our Business Startups Act: New Opportunities to Raise Capital

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## Jumpstart Our Business Startups Act (JOBS Act)

- Signed into law on April 5, 2012
- Purpose: To encourage capital formation, particularly by emerging growth, mid-market and small companies
- The JOBS Act includes some of the most significant changes to securities laws impacting capital raising in the U.S. in decades



## Jumpstart Our Business Startups Act (JOBS Act)

- The JOBS Act encourages private, non-registered offerings of securities and initial public offerings (IPOs)
  - Removes long standing limitations on general solicitations and advertising in certain private placements
  - Permits raising capital through “crowdfunding” transactions
  - Creates a new category of issuer – emerging growth companies (EGCs) - and liberalizes IPO and public reporting obligations for these issuers



## *Expanding Opportunities to Raise Capital in Non-Registered Offerings*

- General Rule: Sales of securities in the U.S. have to be registered with the Securities and Exchange Commission (SEC) under Section 5 of the Securities Act of 1933, as amended (Securities Act)
- The Securities Act permits certain exemptions from the registration requirements for certain non-public and small offerings of securities
- Pursuant to its authority under the Securities Act, the SEC has adopted certain rules and regulations exempting non-public or small offerings from registration under the Securities Act
  - Regulation D (Rules 504,505 and 506)
  - Section 3(b) of Securities Act and Regulation A



## *Expanding Opportunities to Raise Capital in Non-Registered Offerings*

- One of the primary goals of the JOBS Act is to expand opportunities for companies to raise capital in private or small public offerings. These reforms include:
  - relaxing restrictions on general solicitations and advertising in certain private offerings under Rule 506;
  - increasing the exemption for small offerings under Section 3(b) and Regulation A of the Securities Act from \$5 million to \$50 million in any 12 month period;
  - increasing the threshold of shareholders of record for triggering a company’s obligation to register and file reports with the SEC; and
  - permitting companies to raise up to \$1 million in any 12-month period in “crowdfunding” transactions.



## *General Solicitations and Advertising in Private Offerings*

- *Rule 506* - exemption from the registration requirements under federal and state securities laws for offers and sales of securities in private offerings meeting certain conditions.
  - unlimited dollar amount
  - “accredited investors” and up to 35 non-accredited investors
  - exempt from registration under Section 4(2) of Securities Act, which exempts offerings by an issuer “not involving any public offering”
- Prior to the JOBS Act, offers could not be made by any form of general solicitation or general advertising (advertisement, article, notice or other communication published in any newspaper, magazine or similar media, or broadcast over television or radio)



## *General Solicitations and Advertising in Private Offerings*

- The JOBS Act permits an issuer to engage in general solicitations or general advertising in Rule 506 offerings of securities
  - the issuer must take reasonable steps to ensure that all of the purchasers of securities in such offering are “accredited investors” which is generally defined to include certain sophisticated and high net worth investors.
- The JOBS Act also authorizes the use of general solicitations and general advertising in offerings of eligible securities under Rule 144A, so long as the securities are resold only to persons that the seller reasonably believes are “qualified institutional buyers” (QIBs).<sup>1</sup>
- Expands the flexibility of issuers and sellers to market private offerings and resales of securities under these rules - use of Internet and social media.

1. Rule 144A under the Securities Act provides a safe harbor from registration for resales of securities that meet specific requirements to purchasers the seller reasonably believes are QIBs. Although an issuer cannot rely on Rule 144A, the rule permits financial intermediaries to buy securities from an issuer and resell them to an unlimited number of QIBs in transactions that comply with Rule 144A.



## *General Solicitations and Advertising in Private Offerings*

- *Section 201(b) of JOBS Act* - Amends Section 4 of the Securities Act to provide that offers and sales of securities exempt under the revised Rule 506 shall not be deemed public offerings under the federal securities laws “as a result of general advertising or general solicitation.”
  
- The JOBS Act directs the SEC to amend Rules 506 and 144A no later than 90 days after the date of enactment of the JOBS Act.
  - Until the new rules are adopted, Rule 506 and 144A offerings should continue to implement “customary procedures”



## *General Solicitations and Advertising in Private Offerings*

- *Section 201(c) of JOBS Act* - exemption from registration as broker-dealer under Section 15 of the *Securities Exchange Act of 1934, as amended* (Exchange Act) for certain activities in Rule 506 offerings:
  - Maintaining a platform or mechanism for offerings
  - Co-investing in securities
  - Providing ancillary services (due diligence/documentation)
- Limits on exemption:
  - no compensation in connection with the purchase or sale of the securities
  - no possession of customer funds or the securities
  - no statutory disqualification – Section 3(a)(39) of Exchange Act



## *General Solicitations and Advertising in Private Offerings*

- *Accredited Investors* – all purchasers in offerings involving general solicitations or general advertising must be “accredited investors.”
  - Regulation D and Rule 506 provide that a purchaser will be deemed to be an accredited investor for purposes of a Rule 506 offering if the issuer **reasonably believes** the purchaser is an accredited investor.
  - The JOBS Act provides that issuers engaging in general solicitations or general advertising in a Rule 506 offering will need to take **reasonable steps** to verify that all purchasers are accredited investors.
  - SEC rulemaking will determine whether “reasonable steps” will require more than historical market practices for satisfying the “reasonable belief” standard.
  - Issuers and intermediaries may need to revise screening procedures.
- *QIBs* – Offerings under the revised Rule 144A will still only require a reasonable belief that the purchasers are QIBs
  - Rule 144A includes a list of certain methods sellers may rely upon in determining whether a purchaser is a QIB



## *General Solicitations and Advertising in Private Offerings*

- *Additional Considerations*
  - The JOBS Act does not affect the application of anti-fraud provisions of the federal securities laws.
  - For certain offerings, general solicitation or general advertising activities may not contribute significantly to the marketing of the offering.
  - The JOBS Act does not, by its terms, apply to any private placements conducted under Section 4(2) or Section “4(11/2)” of the Securities Act other than those conducted in reliance on Rule 506 or Rule 144A.
  - The Act does not require revisions to Regulation S, which does not permit certain directed selling efforts in the U.S.
  - Securities sold under Rule 144A are not necessarily “covered securities” exempted from *blue sky laws* under Section 18 of the Securities Act.



## *Exchange Act Registration Thresholds*

- Section 501 of the JOBS Act amends Section 12(g)(1) of the Exchange Act - an issuer must register a class of equity securities under the Exchange Act within 120 days after its fiscal year end if on the last day of that fiscal year:
  - Its total assets exceed \$10 million.
  - The class of securities is held of record by either:
    - 2,000 persons; or
    - 500 persons who are not *accredited investors*
- This amendment to Section 12(g)(1) is immediately effective.



## *Exchange Act Registration Thresholds*

- *Calculation of Record Holders*
  - Securities issued under an employee compensation plan in a transaction exempt from registration are not considered to be "held of record" for purposes of the record holder calculation under Section 12(g).
    - the SEC must adopt rules providing a safe harbor - issuers can begin now excluding these holders from their record holder calculations
  - Securities issued under the crowdfunding exemption in new Section 4(6) of the Securities Act (Title III of the JOBS Act) also are excluded from the record holder calculation.
    - the SEC must adopt rules implementing this exclusion of crowdfunding securities within 270 days after the date of enactment
  - Beneficial owners still are not included in the calculation.
  - See FAQ issued by SEC on April 11, 2012



## *Practical Implications for Private Offerings*

- Expands ability to reach out to potential investors and market offerings (Internet; social media)
  
- Allowing general solicitations and increasing the shareholder threshold provides greater flexibility to raise capital in large Rule 506 offerings:
  - unlimited offering amounts;
  - large number of investors;
  - no SEC review of substantive disclosures;
  - no state regulation.
  
- May facilitate secondary market trading of private company securities



# Crowdfunding

- *Crowdfunding: What is it?*
  - capital-raising strategy pursuant to which an issuer raises capital from a large pool of small investors
  
  - Three general models:
    - Donation
    - Reward
    - Equity
  
  - Equity model requires registration or an exemption from registration under the securities laws
    - traditional exemptions are often unavailable or difficult to take advantage of in the crowdfunding context



# Crowdfunding

- *Title III of JOBS Act*
  - *Section 4(6) of the Securities Act* - permits certain issuers to raise up to \$1 million within any 12-month period in a crowdfunding offering without registration under federal or state securities laws.
  - The SEC is required to adopt rules implementing the crowdfunding provisions within 270 days after the enactment of the Act.
    - Offers or sales of securities purporting to rely on the crowdfunding exemption before the SEC adopts final rules are unlawful under the federal securities laws.
  - The dollar thresholds under the crowdfunding exemption are subject to adjustment by the SEC at least once every five years.



# Crowdfunding

- The crowdfunding exemption is not available to:
  - Non-U.S. issuers
  - Reporting companies
  - Investment companies or companies excluded from the definition of investment company by Section 3(b) or 3(c) of the Investment Company Act of 1940
  - issuers and intermediaries disqualified pursuant to rules to be adopted by the SEC
- There are limits on the amount purchased by investors.
- Crowdfunding transactions must be conducted through a broker or funding portal that complies with the requirements of Section 4A(a) of the Securities Act.
- Additionally, the issuer will need to comply with certain disclosure and filing requirements under Section 4A(b) of the Securities Act.



# Crowdfunding

- ***Limitations on investment amounts:***
  - Investors with either an annual income or net worth of less than \$100,000 would be limited to investing the greater of \$2,000 or 5% of the investor's annual income or net worth in the company within any 12-month period.
  - Investors with an annual income or net worth equal to or more than \$100,000 would be limited to investing 10% of the investor's annual income or net worth, not to exceed a maximum amount of \$100,000, in the company in any 12-month period.
  - A natural person's income and net worth are calculated using the SEC rules used to measure the income and net worth of an *accredited investor*.



# Crowdfunding

- *Section 4A(a) of the Securities Act* - an exempt crowdfunding transaction must be conducted through a broker or funding portal
- The JOBS Act adds the term "funding portal" to the defined terms under Section 3(a) of the Exchange Act - any person acting as an intermediary in a crowdfunding transaction that does not
  - Offer investment advice or recommendations;
  - Solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal;
  - Compensate employees, agents or others for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
  - Hold, manage, possess or otherwise handle investor funds or securities; or
  - Engage in such other activities as the SEC may determine appropriate.
- The funding portals will be:
  - subject to the examination, enforcement and other rulemaking authority of the SEC; and
  - a member of a national securities association registered under Section 15A of the Exchange Act (currently only the Financial Industry Regulatory Authority (FINRA)).



# Crowdfunding

- Obligations of broker/funding portal intermediaries in crowdfunding transaction:
  - Ensure that each investor reviews certain information and confirms certain understandings about the risks of the transaction
  - Take measures to reduce the risk of fraud (background checks on the officers, directors and 20% shareholders)
  - No later than 21 days before the first day on which securities are sold to any investor (or such other period that the SEC establishes), provide the SEC and potential investors with certain required disclosures of the *issuer*
  - Ensure that the issuer may only receive the offering proceeds when the aggregate capital raised from all investors equals or exceeds a targeted offering amount, and permit all investors to cancel their commitments to invest
  - Take such actions as the SEC may require by rule to ensure investors do not purchase crowdfunding securities in excess of prescribed limits
  - Comply with any privacy or protection of information requirements the SEC adopts
  - Not compensate promoters, finders, or lead generators for providing personal identifying information for potential investors
  - Prohibit its directors, officers, or partners (or any similar person) from having any financial interest in an issuer that uses its services



# Crowdfunding

- *Obligations of issuer in crowdfunding transaction* - Section 4A(b) of the Securities Act requires each crowdfunding issuer to file with the SEC, provide to investors and the broker or funding portal, and make available to potential investors, certain information:
  - name, legal status, physical address and website address
  - names of its directors, officers and 20% stockholders
  - a description of its business and anticipated business plan
  - a description of its financial condition and certain financial disclosures that include the following, depending on the level of crowdfunding activity undertaken by the issuer during the preceding 12 months:
    - income tax returns for the most recently completed year and financial statements certified by the principal executive officer;
    - financial statements reviewed by a public accountant that is independent of the issuer; or
    - audited financial statements
  - a description of the intended use of the proceeds
  - information about the target offering amount
  - the price to the public of the securities or the method for determining the price
  - certain information about the ownership and capital structure of the issuer



# Crowdfunding

- *Obligations of issuer in crowdfunding transaction:*
  - At least once a year, crowdfunding issuers must also file with the SEC and provide to investors its financial statements and reports of its results of operations, in compliance with rules to be adopted by the SEC.
  - Issuers may not:
    - advertise the terms of the crowdfunding offerings, except for notices directing investors to the funding portal or broker; or
    - compensate any third party to promote crowdfunding offerings through communication channels provided by a broker or funding portal unless that broker or portal complies with rules adopted by the SEC to ensure the third party clearly discloses such compensation.
  
- Limitations on transfer - securities issued in a crowdfunding offering may not for one-year after purchase be transferred by the purchaser unless transferred:
  - to the issuer,
  - to an accredited investor,
  - as part of an SEC-registered offering, or
  - to a family member of the purchaser in connection with the death or divorce of the purchaser or other similar circumstance.



# Crowdfunding

- *Liability* – an investor in a crowdfunding offering may bring an action against the issuer under Section 4A(c) for rescission or damages
  - The issuer will be held liable for written or oral material misstatements or omissions in accordance with Section 12(b) and Section 13 of the Securities Act
  - For purposes of determining liability in a crowdfunding offering, the term issuer includes any person who:
    - is a director or partner of the issuer,
    - is a principal executive officer, principal financial officer, controller or principal accounting officer of the issuer, or
    - offers or sells securities in the offering.
  
- *State Law Considerations*
  - The JOBS Act amends Section 18(b)(4) of the Securities Act to classify securities sold under the crowdfunding exemption as covered securities, exempting them from state *blue sky* registration requirements.
  - States may take anti-fraud enforcement actions.
  - States are limited in their ability to regulate registered funding portals.



# Crowdfunding

- Practical Implications of Crowdfunding Exemption
  - may benefit smaller companies and early stage startups that cannot access traditional capital market and venture capital financing
  - due to fraud concerns, Congress included restrictions and reporting requirements that could make complying with the crowdfunding exemption expensive and time consuming
  - may create a new class of investors with varying levels of net worth and sophistication
  - existing brokers and new funding portals will need to modify or develop procedures to comply with the requirements set out in the JOBS Act and the rules to be adopted by the SEC – these intermediaries will be responsible for a substantial portion of the investor protection in these transactions



## Small Public Offerings under Regulation A

- Section 3(b) of the Securities Act exempts certain small public offerings from registration
  - Prior to the JOBS Act, the SEC had authority to adopt rules exempting offerings of up to \$5 million in any 12 month period
  - The SEC adopted Regulation A to cover these types of offerings
- The JOBS Act increases amount for Regulation A offerings to \$50 million in any 12 month period



## Small Public Offerings under Regulation A

- Regulatory requirements of a Regulation A offering are less stringent than those of a registered public offering
- Historically, Regulation A offerings have not been widely utilized because of the low \$5 million offering cap.
- The JOBS Act seeks to make Regulation A offerings more attractive to companies by increasing this amount to \$50 million.
- Companies that take advantage of Regulation A would be required to file audited financial statements with the SEC annually and also would be subject to other periodic disclosure requirements to be established by the SEC



## On-ramp to IPOs

- The JOBS Act includes a number of reforms to makes IPOs more attractive to certain growth oriented companies
  - Intended to address perception that regulatory requirements had made U.S. capital markets less attractive to smaller and mid-market companies
  - Creates a new class of issuer defined as “emerging growth companies” (EGCs)
  - Facilitates the IPO process for EGCs
  - Reduces certain regulatory requirements for a transition period after the EGC becomes public



# On-ramp to IPOs

- Emerging Growth Companies
  - broadly defined as any issuer that had less than \$1 billion in revenues in its last fiscal year and that has not completed an IPO on or before December 8, 2011.
  - The JOBS Act eases the regulatory burdens of the IPO process
    - reduces the number of years of audited financial statements and selected financial data required to be disclosed in the registration statement from three to two years
    - Reduces other disclosures in the registration statement
    - allows the company to request a confidential, nonpublic review of its registration statement by the SEC prior to public disclosure
    - permits the company to gauge interest in its offering by expanding its ability to communicate with certain institutional investors prior to and during the offering process
    - reduces restrictions on the publication of analyst reports about the company



# On-ramp to IPOs

- Transition to being a public company
  - The JOBS Act makes an IPO more attractive to an EGC by creating a transition period of up to 5 years during which the company does not have to comply with certain ongoing disclosure and reporting obligations under the securities laws.
    - requirement to have independent accountants attest to the effectiveness of internal controls over financial reporting
      - one of the hallmarks of the Sarbanes-Oxley Act
      - costly compliance obligation for many public companies
    - reduced disclosure requirements regarding executive compensation
    - exemption from requirements to hold shareholder votes on executive compensation and golden parachutes
    - relief from complying with financial accounting standards that are not generally applicable to private companies



## On-ramp to IPOs

- This transition period continues until the earliest of:
  - the last day of the fiscal year of the company during which it had total annual gross revenues of \$1 billion or more,
  - the last day of the fiscal year of the company following the 5<sup>th</sup> anniversary of its IPO,
  - the date on which the company has issued more than \$1 billion in non-convertible debt in a 3-year period, or
  - the date the company becomes a “large accelerated filer” as determined under the SEC’s regulations (generally defined as an issuer that has been publicly reporting with the SEC for at least 12 months and has a public float of \$700 million or more).
- Provides EGCs with time to adapt to the reporting obligations and compliance costs of being a public company so that they can focus more of their efforts and resources on growing their business during the period following the IPO



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