insights

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A Newsletter from Shumaker, Loop & Kendrick, LLP | Spring 2012

JOBS ACT

Jumpstart Our Business Startups Act

In March 2012, Congress enacted the JOBS Act, which was signed into law by President Obama on April 5, 2012. The JOBS Act combined a cluster of legislative proposals designed to facilitate the capital raising ability of "emerging growth companies," with the "crowdfunding" proposal receiving the most notoriety. Among other items, noted below, the JOBS Act raised the 500-shareholder trigger to enter the public reporting company system for private companies and community banks.

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To many experienced practitioners, passage of the JOBS Act was surprising, because it was swimming against the tide in favor of tightening capital raising rules. The United States Securities and Exchange Commission ("SEC"), for example, in fulfilling its mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act, last autumn tightened the definition of "accredited investor" under its private offering rules in Regulation D to prohibit an individual using his or her primary residence's value to achieve a net worth in excess of $1 million. Recently, the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory agency charged with oversight of broker-dealers, adopted a rule increasing a broker's due diligence requirements in private placements. Moreover, the SEC, North American Securities Administrators Association (i.e., state securities regulators),

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the Council of Institutional Investors and other prominent constituencies had criticized certain aspects of the bills, especially crowdfunding. Nevertheless, with each political party desiring to appear to be promoting job growth, both Congressional houses passed

the JOBS Act, with an amendment addressing investor protection concerns. Highlights are below.

- **Enhanced Solicitation Capability in Private Placements.**
  Under the securities laws, each sale of a "security" must be registered or exempt from the registration requirements. A commonly used exemption (Rule 506 of Regulation D) is a privately placed sale to certain sophisticated, high-net worth investors called "accredited investors." Currently, Regulation D contains a prohibition against "general advertising and solicitation," and violation of that prohibition results in an issuer being engaged in the unlawful sale of securities. So, for example, posting an offering memorandum or referring to it on an issuer's website or in a news story means that the issuer is engaged in the unlawful sale of unregistered securities. The usefulness of the private placement exemption is further limited by the SEC's interpretation that the "no general solicitation" requirement means that the issuer or its broker must have an existing relationship before a solicitation is made, even if the proposed investor's status as an accredited investor is well known. Under the JOBS Act, the SEC is directed to amend Regulation D within 90 days to eliminate the prohibition on general solicitation or general advertising, provided that all purchasers in the offering are accredited investors – this is not a belief or knowledge standard, they must in fact be accredited investors. Therefore, using such general advertising or solicitation would preclude an issuer from selling securities in a Rule 506 offering to any non-accredited investor. Stated differently, if the issue is marketed through general solicitation and an investor turns out not to be accredited, the issuer will have engaged in the unlawful sale of unregistered securities. The issuer is required to take reasonable steps to verify that each purchaser meets the Regulation D definition of "accredited investor," using methods specified in future rulemaking by the SEC. Currently, issuers typically rely upon an investor's self-certification that it falls within one of the subsections of the accredited investor definition. If an issuer uses a FINRA-registered broker to facilitate its private offering, the broker will be required to comply with all FINRA requirements concerning due diligence and offering procedures.
- **The SEC is directed to adopt a similar amendment to 144A, which is a safe harbor for resales to institutional investors.**
  However, the issuer need only have a reasonable belief that the purchaser is an institutional investor.

The proposal to eliminate "no general solicitation" was previously made by the Middle Market and Small Business Committee of the American Bar Association's Business Law Section, which is chaired by Shumaker's Gregory C. Yadley, who also serves as 1 of 21 members of the SEC's Advisory Committee on Small and Emerging Businesses. The SEC Advisory Committee in February recommended to the SEC that it eliminate the prohibition on general solicitation and advertising in sales of privately-placed securities to accredited investors.

The Act's provisions permitting general solicitation and advertising do not take effect until the SEC amends its rules. It is possible that the SEC will impose additional requirements. Therefore, an issuer conducting a private offering is advised to follow current practices under the present text of all the private offering rules, as well as SEC interpretations thereof.

- **CROWDFUND Act.** This portion of the JOBS Act is so named because the title's complete name is the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012." The Senate amended this title through the Merkley Amendment, which was accepted by the House. Crowdfunding provides an informal approach for startup ventures to pitch their ideas to prospective investors. Selected highlights regarding this new concept are set forth below.

  - An amendment to Section 4(6) of the Securities Exchange Act of 1933, (the "1933 Act"), was created to permit a domestic, private issuer to offer up to $1 million of securities in a twelve-month period through a broker-dealer or funding portal that is registered with the SEC and any applicable self-regulatory organization, unless a portal is exempted by the SEC. A "funding portal" is defined as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(6) of the 1933 Act that does not: (a) offer investment advice or recommendations; (b) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (c) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (d) hold, manage, possess, or otherwise handle investor funds or securities; or (e) engage in other activities prescribed by the SEC.

  - The aggregate amount sold to any investor during the twelve-month period may not exceed the greater of $2,000 or five percent of the investor's annual income or net worth, if either is less than $100,000. For investors with annual income or net worth in excess of $100,000, investment is limited to ten percent of annual income or net worth and a maximum of $100,000. Investors will be required to make affirmations and respond to questions prescribed by the SEC as to their qualification level.

  - With specified exceptions, investors must hold the securities for at least one year.

  - Sale proceeds may not be released to the issuer until the target offering amount has been attained.

  - The issuer must give to each investor education materials and specified disclosure prescribed by the Act and as to be further required by the SEC. To note a few examples, for offerings of less than $100,000, the financial statements must be certified by the issuer's principal executive officer. For offerings between $100,000 and $500,000, the financial statements must be reviewed by an independent public accountant using professional standards or standards prescribed by the SEC. For offerings in excess of $500,000 (or such other amount established by the SEC), audited financial statements are required.

  - The broker-dealer or funding portal must take measures to reduce fraud risk, including obtaining a background and securities enforcement regulatory history check on each officer, director and person holding twenty percent of its outstanding equity.

  - Subject to any additional requirements to be prescribed by the SEC, offering materials must be filed with the SEC not later than twenty-one days prior to the first sale.

  - Issuers must file with the SEC and provide to investors annual reports of the results of operations and financial statements, and such other matters as the SEC shall prescribe.
  - The CROWDFUND Act also contains a new liability section for material misstatements and omissions.

  - The CROWDFUND Act preempts the registration, documentation and offering requirements of state law, although state securities administrators retain the right to require notice filings or to take enforcement action, especially with respect to fraud or deceit and other unlawful conduct. Fees relating to a notice filing may be charged only by the state of the issuer's principal place of business or any state in which investors of fifty percent or more of the offering are residents.

- **Eases the Path for Emerging Growth Companies.** Growing companies that desire to go public through an initial public offering ("IPO") will have an easier path under the new category of an "emerging growth company," which is defined as a company with less than $1 billion in annual gross revenues during its most recently completed fiscal year. The status will last until the earliest to occur of: (a) the last day of the fiscal year in which it had total annual gross revenues of $1 billion or more (as adjusted for inflation); (b) the last day of the fiscal year following the fifth anniversary of its first sale of common equity securities under a registration statement; (c) the date on which it has, during the previous 3-year period, issued more than $1 billion in non-convertible debt; or (d) the date on which it is deemed to be a "large accelerated filer," under the SEC's regulations under the Securities Exchange Act of 1934, as amended (the "1934 Act"). Being an emerging growth company confers benefits in the IPO registration process, such as presenting two, rather than three, years' of audited financial statements, and a two, rather than three, year period for presenting disclosure as to selected financial data and Management's Discussion and Analysis. Market participants, however, might expect financial statements for the longer period.

Relaxation of certain IPO rules was criticized after passage of the JOBS Act when Groupon's IPO revealed accounting irregularities. Under the new procedures, an emerging growth company could privately submit its draft IPO registration statement to the SEC and correct issues raised by the SEC without public disclosure of the corrections.

Additionally, the reduced executive compensation disclosure requirements applicable to smaller reporting companies would be applicable. After the initial public offering, certain requirements would be phased in, such as the Sarbanes-Oxley requirement to have independent auditors attest to the issuer's internal control over financial reporting. While it is an emerging growth company, the issuer would be exempt from the rules on say-on-pay voting, application of new accounting principles that are not applicable to non-reporting companies and mandatory auditor rotation requirements.

- **1934 Act Thresholds.** Under Section 12(g) of the 1934 Act and SEC rules, a company with more than 500 shareholders of record and $10 million in assets must comply with all the public company requirements, including annual and quarterly reporting, as well as compliance with the Sarbanes-Oxley requirements. The 500-shareholder requirement has not been updated since it was originally adopted in 1964, but the JOBS Act increases this threshold. Under the JOBS Act, the 1934 Act requirements will become applicable within 120 days after the last day of the fiscal year in which the issuer has total assets exceeding $10 million and a class of equity security (other than an exempted security) held of record by either (a) 2,000 persons, or (b) 500 persons

who are not "accredited investors." Additionally, the definition of "held of record" does not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the 1933 Act, and the SEC is directed to adopt safe harbor provisions for determining when this definition has been satisfied. The CROWDFUND Act directs the SEC to adopt a rule exempting crowdfunding investors from the Section 12(g) threshold numbers on either a conditional or an unconditional basis. Importantly, the JOBS Act does not require the amendment of the shareholder counting rules under section 12(g)(5) to include "beneficial holders," but it is possible that this issue will be revised when the SEC reviews the counting rules. While the increase in the number of shareholders necessary to trigger the public reporting obligations is welcome, how and when the "accredited investor" test is applied and the impact of shares issued under employee benefit plans and crowdfunding offerings will complicate this relief. Community banks and bank holding companies faired better in the legislation in the context of counting shareholders (see page 1 text box). Note that the legislation did not increase the 300 shareholder threshold for deregistration as was done for banking entities.

• **Regulation A.** Regulation A is an alternative exempt offering process that is rarely used due to its limited offering amount and required filing of a detailed disclosure document with the SEC for review prior to commencing an offering. Congress hopes to enhance the utility of Regulation A by increasing the offering threshold from $5 million to $50 million. Interestingly, the law requires that companies using the revised Regulation A file financial statements with the SEC after the offering and allows the SEC to adopt such other requirements as it "may deem necessary in the public interest."

• **Regulations.** As is frequently the case with new securities laws, Congress has left much to be done by the SEC through the adoption of regulations. Even though time lines are set for these regulations, the SEC still is digging out from under the regulations required by Dodd-Frank and it is unclear if the required time lines can be met.