HANDLER THAYER, LLP

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Handler Thayer Commercial Practice Alert
The JOBS Act: A Revolutionary Opportunity On Hold

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On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the "JOBS Act") into law. The JOBS Act encompasses several significant changes to the federal securities laws, providing a proverbial facelift for the private capital raising provisions in the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), and the Sarbanes-Oxley Act of 2002 ("SOX"). While President Obama's signature ushers in a new era of fundraising opportunities for private companies, the JOBS Act leaves the details of crowdfunding and private offerings in the hands of the Securities and Exchange Commission (the "SEC"). As a result, the bi-partisan legislation initially developed in President Obama's Startup Initiative, will now be turned over to the SEC who has not been particularly excited about drafting quick and easy regulations to implement these ground breaking initiatives. Although the legislation will provide new and innovative fundraising strategies for many small businesses, the SEC's rulemaking process will likely delay the implementation of the JOBS Act for several months, if not longer.

Congress Approves Crowdfunding

The most discussed, debated, and celebrated provision of the JOBS Act is the crowdfunding exemption created in Title III. The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, or the "CROWDFUNDING Act" allows issuers to raise $1 million in a 12-month period from investors over the Internet.[1] Investors are limited to investing: (i) the greater of $2,000 or 5% of the investor's annual income or net worth, if the investors income or net worth is under $100,000; or (ii) the lesser of $100,000 or 10% of the investor's annual income or net worth, if the investor's annual income or net worth is $100,000 or greater.[2] The only catch is that these offers must be made through a Broker-Dealer or a "funding portal" that is registered with the SEC,[3] pursuant to rules and regulations that are yet to be developed.

In addition to requiring a "registered" intermediary to administer the offering, the JOBS Act requires issuers to comply with new disclosure requirements pursuant to such rules and regulations that, once again, are to be developed by the SEC. The outcome of the SEC's rulemaking will likely increase the overall regulatory burden of doing a Crowdfunding Offering which will make it more costly for issuers.

Under the JOBS Act, intermediaries will be required to:

(i) Register with the Commission as a broker, or a funding portal[4];

(ii) Register with any applicable self-regulatory organization (*i.e.* FINRA);

(iii) Provide detailed disclosures, including risks, to investors;

(iv) Ensure that each investor:
   a. Review education information;
   b. Positively affirm that the investor understands that he or she is risking the loss of the entire investment; and,
   c. Can bear such loss;

(v) Obtain background and a securities enforcement regulatory history check on each officer, director, and person holding more than 20% of the outstanding equity;

(vi) Provide the SEC and investors with any information provided by the issuer within 21 days prior to the first day of sales;

(vii) Ensure that the issuer cannot access offering proceeds until the target offering amount is raise and allow all investors to cancel commitments;

(viii) Ensure that investors do not exceed the 12-month investing limitations on securities purchased under Section 4(6) of the Securities Act;

(ix) Protect the privacy of information collected from investors;

(x) Refrain from compensating promoters, finders, or lead generators for personal identifying information of any potential investor; and,

(xi) Prohibit directors, officers, or partners (or anyone similar person) from having any financial interest in the issuer using its services.[5]

In addition to the restrictions and obligations placed upon intermediaries, the JOBS Act requires issuers to provide information to investors and the SEC that is typically required for registered offerings. Issuers will be required to provide:

(i) The name, legal status, address, and website of the issuer;

(ii) Names of directors, officers (or similarly situated persons) and investors owning more than 20% of the outstanding equity in the company;

(iii) A description of the issuer's business and a business plan;

(iv) A description of the financial condition of the company, including:

   a. If the target offering amount is $100,000 or less, then the most recent year's income tax returns (if any); as well as financial statements of the issuer certified by the principal executive officer of the issuer as being true and complete in all material aspects[6];

   b. If the target offering amount is over $100,000, but not more than $500,000, the issuer must provide financial statements reviewed by an independent public accountant; and,

c. If the target offering amount is over $500,000, the issuer must provide audited financial statements;

(v) A description of the offering sought by the issuer regarding the targeted offering amount, the deadline of the offerings, and regular updates regarding process in meeting the target offering amount;

(vi) Determination of the price of the securities, including a written disclosure of the final price of the securities with a reasonable opportunity to rescind the commitment; and,

(vii) A description of ownership and capital structure, including the terms and conditions of the offering and the risks to purchasers regarding minority ownership in the company.[7]

In addition, issuers are required to file with the Commission and provide investors annual reports of the results of operations and financial statements of the issuer.[8] Finally, the JOBS Act does not entirely preempt state regulation, only prohibiting states from collecting fees in connection with a crowdfunding offering, except for the state of the issuer's residence and the state where more than 50% of its shareholders reside.[9] This suggests that the SEC and state securities regulators could develop a system similar to the current Regulation D state filings, still requiring disclosures be made in a timely manner to every state where an investor resides, despite the state's inability to collect fees. For now, it is uncertain what additional steps or disclosures will be required by the SEC. Congress has given the SEC 270 days to conduct rulemaking, at which time crowdfunding should become available for issuers; however, after the SEC rulemaking process, the rules and regulations for crowdfunding may substantially change the essence of the JOBS Act and create unforeseen obligations for both funding portals and issuers.[10] Consequently, although there have been numerous claims of crowdfunding platforms going live in the last week, issuers should abstain from doing a crowdfunding offering until the SEC has completed the rulemaking process to avoid any potential liability of violating a currently unwritten rule.

Although the creation of crowdfunding has been much heralded by small businesses as a an opportunity to both provide greater access to capital for startups and allow smaller investors to participate in private companies, the anticipated additional layers of regulation and disclosure, usually reserved for public companies, will be very expensive for small companies. The costs of potential audits, legal fees for the drafting of a Private Placement Memorandum, and the ongoing requirements to provide annual reports could be onerous for a young business and make crowdfunding potentially more expensive than a traditional private offering under Regulation D. This raises questions regarding whether crowdfunding can be a successful fundraising strategy and if so, what type of business would benefit from crowdfunding. First, it is clear from the JOBS Act that crowdfunding will not be as simple as posting a blog or update on a site like LinkedIn or Facebook. Rather, the JOBS Act has created a complex set of regulations that will necessitate substantial legal and financial help to navigate the offering. Second, the costs for intermediaries to comply with the forthcoming SEC rules and register with a self-regulated entity will also be passed down to issuers, on top of their fees to access the crowdfunding platform, creating additional charges that are not currently associated with private offerings. Thus, a crowdfunding offering could be more expensive to complete and comply with the ongoing

obligations than a traditional Regulation D offering. As a result, it is probably unlikely that companies seeking less than $100,000 will find crowdfunding beneficial.

Congress Allows for General Solicitation in Regulation D and Section 4(2) Offerings

Despite the hype associated with Crowdfunding, the JOBS Act opened a potentially bigger door for future offerings under Regulation D. Under Title II (Access to Capital for Job Creators) of the JOBS Act, issuers relying on a Rule 506 exemption under Regulation D of the Securities Act ("Rule 506") will be able to generally solicit investors, including through the Internet, as long as sales are only made to accredited investors.[11] This, in essence, creates an opportunity to solicit accredited investors using sales strategies similar to a public offering with the disclosure obligations of a private offering.[12]

The removal of the general solicitation rule provides greater flexibility and opportunities for small and startup businesses. Since many private offerings are typically restricted to accredited investors in order to limit disclosures and prevent potential securities laws violations, the opportunity to publicize securities offerings as public offerings will open up the private securities offerings to persons beyond those people who have an established prior relationship with the issuer. Determining who was an eligible investor in a private offering when general solicitation was prohibited was perhaps one of the most complicated parts of conducting a private offering. Private issuers never had clear direction on who they could solicit for their private offering. The ability to publicize the offering over the internet or in print will provide issuers with access to investors that were never before possible and will potentially legitimize fundraising activity that was technically crossing the public/private line in the sand.

The SEC will still have the final say on how these changes can be used by issuers, but was only given 90 days to develop final rules to implement changes to Regulation D.[13] Consequently, general solicitation for Rule 506 offerings, the most popular and widely-used transactional exemptions, should be available for issuers this year. Issuers who are looking to raise money sooner rather than later, may want to take advantage of Rule 506, as opposed to waiting for final rules on Crowdfunding.

Congress Raises Caps on Investor Limitations under 12(g) of the Exchange Act

In response to the dilemma that Facebook recently bumped into (the 500 shareholder limitation), Congress provided some relief under Title V (Private Company Flexibility and Growth) of the JOBS Act. Title V amend Section 12(g)(1)(A) of the Exchange Act, which previously required a company to register if a company had (i) more than $10 million in assets; and (ii) 500 or more investors. Under the amended Section 12(g)(1)(A) an issuer with at least $10 million in assets can have as many as 2,000 investors including up to 500 unaccredited investors.[14] Furthermore, two groups of investors will be excluded from the investor limitation: (i) investors participating in a crowdfunding offering under Section 4(6) of the Securities Act; and (ii) employees receiving equity through an employee compensation plan.[15] By expanding the investor limitations under Section 12(g)(1)(A), small companies are able to stay private longer and avoid the costly registration process before the business is ready to take on the

obligations of being a publicly traded company. In addition, this allows companies to do additional fundraising rounds (or larger rounds) prior to making the leap to the public sector.

The New Landscape of Private Funding and Going Public

The JOBS Act also created changes in the law to help ease the transition for small companies that want to go public. First, the "testing the waters" exemption under Regulation A of the Securities Act has been increased from a capital limitation of $5 million to $50 million.[16] This jump was in recognition that a $5 million offering was not enough to capture the interest of investors for companies to properly gauge whether going public was a realistic possibility. Issuers will still be required to file a Form 1-A with the SEC and the file audited financial statements annually, but the increase in offering cap will now help offset the potential cost burden of these disclosures.[17] Second, when the company does go public, the JOBS Act has provided substantial relief from the financial reporting requirements under SOX.[18] This relief targets "Emerging Growth Companies," which Congress defines as companies that have a total annual gross revenue of less than $1 billion.[19] Congress intended that the minimization of disclosure requirements would relieve the onerous and costly regulation burden incurred by public companies related to proper accounting oversight.

The JOBS Act has created numerous opportunities for small businesses and startups to grow through easing the burdens of some of the securities laws and providing unprecedented access to capital. In addition, the JOBS Act provides these opportunities throughout the entire life-cycle of small business: from the seed-round of crowdfunding through the "on-ramp" of the Emerging Growth Company. However, the JOBS Act has not reached the finish line as of yet. It is now in the hands of the SEC, which has already signaled that it may drag its feet during the rulemaking process and delay the implementation of the law. The SEC has already spoken out against certain provisions of the JOBS Act, including Crowdfunding, and now has the opportunity to burden it with excessive regulation making it less practical for small companies. Over the next several months, the devil will be in the details as we look at what the SEC has to say about the implementation of the JOBS Act and what it means for private capital raising.

If you have any questions regarding this press release, please contact Steven J. Thayer at (312) 641-2100. .

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[1] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(a) (2012).

[2] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(a) (2012).
[3] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(a) (2012).
[4] Under Section 304 of the JOBS Act, Funding Portal is defined as an intermediary in a transaction involving the sale of a security under Section 4(6) of the Securities Act that does not:

(i) Offer investment advise or recommendations;
(ii) Solicit purchases, sales or officers to buy the offered securities on its website;
(iii) Compensate employees, agents, or other person for such solicitation or based on the sale of securities;
(iv) Hold, manage, possess, or handle investor funds or securities; or,
(v) Engage in such other activities as the Commission determines appropriate by rule.

[5] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(b) (2012).
[6] Note that this will cause the principal executive officer to have personal liability for all financial statements provided to the SEC, similar to executive officers of public corporations under SOX.
[7] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(b) (2012).
[8] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(b) (2012).
[9] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 305 (2012).
[10] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 302(c) (2012).
[11] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 201(a) (2012).
[12] However, it should be noted that Section 201(c) of the JOBS Act amends Section 4(b)(1)(C) of the Securities Act to include an exemption from registration as a broker-dealer if the person or entity providing "ancillary services." Ancillary Services are defined as due diligence services and the provisions of standardized documents. According to the definition, the person or entity providing documents may not "negotiate the terms of the issuance for and on behalf of third parties" and issuers cannot be required to use the standardized documents. From the definition, there is a concern that this could exclude attorneys from the broker-dealer exemption. This definition needs to be expanded or interpretive guidance will have to be developed to define what a standardized document encompasses.
[13] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 201 (2012).
[14] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 501 (2012).
[15] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. §§ 303 and 502 (2012). Under Section 503, Congress is requiring the SEC to create a safe harbor provisions for issuers to follow when issuing employee incentive plans to comply with the exemption.
[16] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 401 (2012).
[17] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 401 (2012).
[18] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. §§ 101-108 (2012).
[19] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 101 (2012).