

JOB Act: What Does It Really Mean For the Future of Private Placements?

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Background

- March 22, 2011 Congressman Darrell Issa (R, CA), Chairman of the House Committee on Oversight and Government Reform, sent a letter to Mary Shapiro, Chairman of the SEC.
- Main Points of the letter:
 - 1) Raise concerns about whether the current securities regulatory framework had a negative impact on capital formation; and
 - 2) Raise concerns about the extent to which the current SEC regulations potentially limited capital raising activities by small and emerging companies.
 - 3) Raised concerns regarding the way holders are counted and how many holders should trigger registration

Background

- After extensive research by the SEC, as well as multiple bills sent to the House and the Senate the Jumpstart Our Business Startups Act was signed by President Obama on April 5, 2012.
- The SEC now has specific deadlines to prepare new rules to govern the changes made to various sections of the Securities Act of 1933 and the Securities and Exchange Act of 1934.

Relevant Sections Addressed and Created by JOBS Act

- Securities Act Regulation D Rule 506
- Securities Act Rule 144A
- Crowdfunding
- Securities Exchange Act 12(g)

What is Regulation D?

- Regulation D – **17 C.F.R. §230.500 *et seq***
- Regulation D (Reg D) contains three rules that provide exemptions from the registration requirements. These rules allow some companies to offer and sell their securities without having to register the securities with the SEC:
 - Rule 504;
 - Rule 505; and
 - Rule 506

What is Rule 506?

- “Safe harbor” for the private offering exemption of § 4(2) of the Securities Act. Under this exemption, companies can raise an unlimited amount of money, but they were still subject to certain standards of conduct.
- § 230.506 – Exemption for Limited Offers and Sales without regard to Dollar Amount of Offering
 - § 230.504 - Exemption for Limited Offerings and Sale of Securities not exceeding \$1,000,000
 - § 230.505 - Exemption for Limited Offerings and Sale of Securities not exceeding \$5,000,000

Before the JOBS Act: General Conditions

- To qualify for an exemption under this section, offers and sales must satisfy all of the terms and conditions of §§ 230.501 and 230.502.
 - 17 C.F.R. § 230.506 (b)(1).

Before the JOBS Act: Specific Conditions

- The company ***cannot*** use general solicitation or advertising to market the securities;
- The company may sell its securities to an ***unlimited number of "accredited investors" and up to 35 other purchasers***. If the investor is a non-accredited investor – either alone or with a purchaser representative – it must be sophisticated;
- Companies must decide what information to give to accredited investors. However, they must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings;
- The company must be available to answer questions by prospective purchasers;
- Financial statement requirements are the same as for Rule 505; and
- Purchasers receive “restricted securities” – the securities cannot be sold for at least a year without registering them.
- 17 C.F.R. § 230.506 (b)(2).

Relevant Rule 502 Language

- § 230.502 (c)(1) and (2): Limitation on manner of offering
 - Except as provided in § 230.504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:
 - (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
 - (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising; provided however, that publications by an issuer of a notice in accordance with §230.135c or filing with the Commission by an issuer of a notice of sales on Form D in which the issuer has made a good faith and reasonable attempt to comply with the requirements of such form, shall not be deemed to constitute general solicitation or general advertising for purposes of this section.

After the JOBS Act: Rule 506

- “. . . the Securities and Exchange Commission shall revise its rules, issued in section 230.506 of title 17, Code of Federal Regulations, to provide that ***the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors.*** Such rules shall require the issuer to take ***reasonable steps to verify that purchasers of the securities are accredited investors*** using such methods as determined by the Commission.”
- JOBS Act § 201(a)(1).

What Do These Changes Mean?

Before:

- The company ***cannot*** use general solicitation or advertising to market the securities;
- The company may sell its securities to an ***unlimited number of "accredited investors" and up to 35 other purchasers.***

Now:

- "the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title ***shall not*** apply to offers and sales of securities made pursuant to section 230.506"
- "***all*** purchasers" of the securities must be "***accredited investors***"
- By lifting the ban on general advertising and general solicitation the SEC opened the door for small businesses to reach larger investors. However, by stipulating that "all" of the purchasers be accredited investors it runs the risk of eliminating a potential group of investors as well.

What is an Accredited Investor

- Defined in 17 C.F.R. §230.501(a)
- Most commentaries have focused on the monetary requirements for natural persons:
 - 501(a)(5)(i) and (ii)
 - Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds \$1 million – excluding the value of the primary residence;
 - Any natural person with income exceeding \$200,000 in each of the two years most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year

Accredited Investor Continued...

- The JOBS Act requires that, under the revised rules, issuers utilizing general advertising or general solicitation in connection with Rule 506 offerings take ***reasonable*** steps to verify that the purchasers are accredited investors using methods to be determined by the SEC.
- As of now, the SEC has yet to determine those methods. Until they do, market participants should continue to comply with the existing requirements for the Rule 506 exemption.

Before the JOBS Act: Rule 144A

- **17 C.F.R. § 230.144A** – Private Resale of Securities to Institutions
- Subsection (d)(1) of Rule 144A specifically states: “Conditions to be met. To qualify for exemption under this section, an offer or sale must meet the following conditions:
 - (1) The securities are ***offered or sold only to a qualified institutional buyer*** or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.” 17 C.F.R. § 230.144(A)(d)(1).
 - Subsection (d)(1) lists five (5) non-exclusive methods of establishing the prospective purchaser’s ownership and discretionary investments of securities which range from the most recent publicly available financial statements to a certification by the chief financial officer – or other executive officer of the purchaser – the specifies the amount of securities owned and invested.

After the JOBS Act: Rule 144A

- “. . . the Securities and Exchange Commission shall revise subsection (d)(1) of section 230.144A of title 17, Code of Federal Regulations, to provide that securities sold under such qualified exemption ***may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising***, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.”
- It is worth noting, that any changes to Rule 12(g) of the Exchange Act will impact issuers using Rule 144A because it changes the registration threshold.

New: Crowdfunding

- What does Crowdfunding stand for?
 - Creation of Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (CROWDFUND Act)
 - Title III of the JOBS Act
- What is Crowdfunding?
 - The use of the Internet to raise small amounts of money from a large number of contributors.
 - Essentially, it works based on the ability to pool money from individuals who have a common interest and are willing to provide contributions toward a venture.
 - Can, potentially, add up to a large – and critical – amount of capital.
 - The JOBS Act specifically amends Section 4 of the Securities Act to exempt issuers from the requirements of Section 5 of the Act when they offer and sell up to \$1 million in securities. However, the individual investments must not exceed certain thresholds and the issuer satisfies other conditions in the JOBS Act.

New Exemption: Section 4(6)

- Offers significant promise for small business issuers who face a capital funding gap because traditional sources of business financing – bank lending, venture capital, and angel investors – are not available for most startups.
- See Attached language for specific requirements.

New Exemption: Section 4(6)

- Before the new exemption, issuers who wanted to sell securities through crowdfunding faced two obstacles:
 - 1) absent an exemption, the offerings would have to be registered under the Securities Act of 1933;
 - 2) crowdfunding web sites hosting offerings of securities could be required to register as brokers under the Securities Exchange Act or as investment advisors under the Investment Advisors Act
- *In the Matter of Michael Migliozi and Brian William Flatow*. Release No. 33-9216 (June 8, 2011).

New Exemption: Section 4(6)

- Section 4(6) exempts offerings of \$1 million or less, provided that no investor exceeds an individual investment cap based on the investor's annual income and net worth.
- Anyone can invest so long as they meet the requirements for investors.

Potential Issues

- Potentially dangerous combination of investment risk and relatively unsophisticated investors.
- Involves sales to the general public not just sophisticated or accredited investors
- Inconsistencies in the drafting language makes implementation of the exemption difficult
- Requirements of the exemption make it too complicated and expensive for small businesses
- Overall regulation to ensure the requirements are being met while preventing fraud
 - Takes away the option for having an open , public web site

JOBS Act: Title V – Private Company Flexibility and Growth

- As amended by Title V, the Exchange Act Section 12(g) now requires registration if:
 - At the end of its fiscal year, a company has at least \$10 million in assets and a class equity securities held of record by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors
 - Banks and holding companies are not required to register unless they have, at the end of the fiscal year, at least \$10 million in assets and class of equity securities held of record by 2,000 or more persons

JOBS Act: Title V – Private Company Flexibility and Growth

- Prior to the enactment of the JOBS Act, under Section 12(g)(4), an issuer could deregister a class of equity securities when: (i) the issuer has \$10 million or less in assets and the class of equity securities is held by fewer than 500 holders of record; or (ii) the class of equity securities is held by few than 300 holders of record.
- Now, the 300 persons held of record test has been increased to 1,200 persons. However, that is only for banks and bank holding companies. It did not increase the test for deregistration for issuers that are not banks or bank holding companies.

Additional Sites and Information to Check Out

- Letter from Issa to Schapiro – www.sec.gov/news/press/schapiro-issa-letter.pdf
- Testimony Concerning the “JOBS Act in Action Part II: Overseeing Effective Implementation of the JOBS Act at the SEC – June 28, 2012: www.sec.gov/news/testimony/2012/tso62812mls.htm
- SEC Frequently Asked Questions:
 - Implementing the JOBS Act
 - Crowdfunding – www.sec.gov/divisions/marketreg/tmjjobsact-crowdfundingintermediariesfaq.htm
- CNN Money: 8 Crowdfunding Sites to Watch: <http://money.cnn.com/galleries/2012/technology/1204/gallery.crowdfunding-startups/index.html>
- The Crowdfund Act of 2012 (Title III of the JOBS Act): Summary of Law and Major Issues Raised in the “Pre-Comments” to the SEC by Sara Hanks
- The New Federal Crowdfunding Exemption: Promise Unfulfilled, Forthcoming, *Securities Regulation Law Journal*, Vol. 40, No. 3 (Fall 2012) by C. Steven Bradford
- VCExperts: https://vcexperts.com/buzz_articles