

The JOBS Act: New Avenues for Raising Capital

Key Takeaways:

1. Crowdfunding will now be allowed under United States securities laws, allowing start-ups to raise up to \$1 million per year using the internet and social media. Crowdfunding offerings must be made through a registered intermediary.
2. In certain offerings sold solely to accredited investors, general solicitations will be permitted, including through the internet, with no dollar limit. These offerings will not require the use of intermediaries, so they may be made by a company on its own website.

President Obama is expected to sign, possibly as early as this week, the Jumpstart Our Business Startups Act (the "JOBS Act"). The legislation is intended to make it easier for companies to raise capital in public and private transactions. The CROWDFUND Act, adopted as part of the JOBS Act, allows companies to solicit investors on the internet through third party "crowdfunding" platforms, providing start-up and other companies seeking capital with access to new potential sources of funding. Apart from the CROWDFUND Act, the JOBS Act, for the first time, permits offerings under Rule 506 of Regulation D to be made through so-called "general solicitation" or advertising, including advertising on the issuer's own website, as long as the only purchasers in the offering are accredited investors.

The CROWDFUND Act

Crowdfunding, also referred to as crowdsourcing, is the process of raising money by soliciting funding from many people through the internet and social media. Crowdfunding websites have gained popularity in recent years, providing a platform for individuals to make small contributions to companies or artistic projects, typically as a pure contribution for no direct benefit other than assisting a worthwhile project or as an advance purchase of a product that a new company is seeking to bring to market. Until now, however, companies' ability to access the substantial pool of capital available through crowdfunding has been limited because soliciting the purchase of company securities through the internet would constitute a "public offering" requiring registration under securities laws, a mammoth undertaking that is typically beyond the resources of a startup or early-stage company. The CROWDFUND Act creates a new exception to the registration requirement under securities laws for securities offerings conducted through crowdfunding, subject to limitations on the total amount offered, how much a single investor may invest, and certain other restrictions intended to protect investors.

In general, the CROWDFUND Act permits companies to raise up to \$1,000,000 in any twelve month period in securities offerings conducted through third-party "intermediary" crowdfunding platforms. There is no limit on the number of investors, but the amount each investor is permitted to invest in any one company is limited based on the investor's annual income and net worth. Investors with less than \$100,000 of annual income or net worth may invest up to the greater \$2,000 or 5% of their annual income or net worth. Investors with more than \$100,000 of annual income or net worth may

invest up to 10% of their annual income or net worth, subject to a maximum investment of \$100,000. These dollar thresholds are subject to periodic adjustments based on the Consumer Price Index. Investors will be prohibited from selling any securities acquired in a crowdfunding offering for one year following acquisition, with exceptions for sales back to the company, certain estate planning transfers and sales to "accredited investors", a defined class of investors under the Securities Act that generally includes high-income or high net worth individuals, companies with more than \$5 million in assets and certain institutions.

While the new crowdfunding exemption represents a substantial revision of securities laws governing capital raising, companies will still be required to comply with numerous investor-protection requirements. As noted above, crowdfunding offerings must be conducted through third-party intermediaries subject to regulation by the SEC, so companies will not be able to simply offer their securities through their own websites. Both the company and the intermediary will be responsible for ascertaining investors' eligibility to purchase securities in the offering, which is generally done by requiring the investor to answer specific questions and make certain representations at the time of purchase. Importantly, the company will be prohibited from taking possession the invested funds until the full amount of the offered securities are sold.

In connection with each offering of securities, the offering company will be required to provide potential investors with information regarding the company, its business plan, the valuation of the securities offered, the identity of its directors, executives and significant stockholders, as well as financial data. For offerings of \$100,000 or less, the company must provide its most recent annual tax returns (if any) and financial statements certified by the company's principal executive officer. For offerings between \$100,000 and \$500,000, financial statements reviewed by an independent certified public accountant must be provided, and for offerings in excess of \$500,000 audited financials must be provided. Companies that have conducted crowdfunding offerings will also be required to deliver to investors and the SEC reports of the results of operations and financial statements on an annual basis thereafter.

Securities offered under the crowdfunding exemption will be exempt from registration under each state's separate securities laws, which relieves the offering company from the onerous and expensive process of registering its securities in each state in which offered (which given the online nature of crowdfunding would necessarily be nationwide.)

The crowdfunding exemption will not be available to a company if any of its "covered persons" – generally speaking, its officers, directors, 10% or greater stockholders or any person that receives (or affiliated with a person or entity that receives) compensation for promoting investments in the company – has been convicted of any crime relating to securities fraud or barred by any securities or financial regulator from activities in the securities or financial industry.

Prior to the CROWDFUND Act becoming effective, the SEC will need to adopt numerous rules to implement its provisions. The SEC is required to adopt implementing rules within 270 days of the legislation's enactment.

The New General Solicitation Exemptions under Rule 506

In addition to the CROWDFUND Act, the JOBS Act includes a number of other provisions intended to facilitate capital raising for smaller companies. One of these changes is to permit "general solicitations" (or in plain English, advertising) in offerings under SEC Rule 506 purchased solely by accredited investors. The statute also specifies that a website that acts as a "platform" for these

Rule 506 offerings and that meets certain requirements will not be required to register as a broker dealer under applicable law, substantially easing the regulatory burden and opening the door to an expansion of these platforms to locate funding sources. However, unlike the CROWDFUND Act, offerings made pursuant to Rule 506 are not required to be made through intermediary platforms (although they can be), and can instead be made by the company seeking funds directly, including over its own website. In either case, however, only accredited investors may participate in offerings conducted under Rule 506 through public advertising and the issuer will be required to take reasonable steps to verify the accredited status of investors. In addition, unlike offerings under the CROWDFUND Act, there are no mandatory information requirements in Rule 506 offerings made solely to accredited investors, and no limit on the amount that may be raised or the number of accredited investors who may purchase securities offered in this manner. The SEC is required to adopt implementing rules for the Regulation D changes within 90 days of the enactment of the JOBS Act.

The Jobs Act also increases from 500 to 2,000 the number of stockholders that a non-public company with over \$10 million in assets may have before it becomes required to file public reports with the SEC (with the caveat that at least 1,500 of those 2,000 must be "accredited investors"; in other words, if a company has more than 500 non-accredited investors, it will still need to register.) Significantly, however, the legislation provides for the SEC to adopt regulations exempting from these limits stockholders acquiring shares through a crowdfunding offering validly conducted under the CROWDFUND Act. Employees acquiring equity securities in exempt offerings are also excluded from counting against the numerical stockholder limits.

The direct access to new and expansive sources of capital that the JOBS Acts provides should prove very beneficial to smaller companies and entrepreneurs and founders seeking early-stage capital. However, company managers and founders should not lose sight of the fundamental securities laws that apply to all offerings of investments in securities, whether through crowdfunding, other private placements, IPOs, transactions between stockholders or otherwise. In particular, company managers must remain aware of the extensive anti-fraud provisions under Federal and state securities laws, which, by their broad scope and applicability, prohibit material misrepresentations and omissions of material facts in connection with securities offerings.

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