

Morgan Lewis

article

communicate



JOBS Act
(Focus on Crowdfunding)

JOBS Act (Focus on Crowdfunding)

Legislation exempts emerging growth companies from certain financial disclosure and governance requirements for up to five years and provides a new form of financing to small companies.

Showing strong support for the measure, the House of Representatives on March 27 approved the Jumpstart Our Business Startups Act (the JOBS Act) by a vote of 380 to 41. The legislation was passed in the form approved by the Senate on March 22 by a vote of 73 to 26. President Obama has said that he will sign the new legislation.

The JOBS Act amends various provisions of the federal securities laws to simplify the sale of securities and increase the threshold number of record holders required to trigger the reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act). Companies that fall under the newly defined category of emerging growth company will particularly benefit from the JOBS Act's simplified financial disclosure and governance requirements. In general, under the JOBS Act, a company is defined as an emerging growth company if its initial public offering of common equity securities (IPO) was after December 8, 2011, and it had less than \$1 billion of total annual gross revenues during its last completed fiscal year. A company will no longer qualify as an emerging growth company after the earliest of (i) the completion of the fiscal year in which the company has total annual gross revenues of \$1 billion or more, (ii) the completion of the fiscal year of the fifth anniversary of the company's IPO, (iii) the company's issuance of more than \$1 billion in nonconvertible debt in the prior three-year period, and (iv) the company's becoming a larger accelerated filer, as defined under the Exchange Act.

Other important provisions of the JOBS Act include a relaxation of the general solicitation and general advertising prohibition, a new exemption for public offerings of securities in amounts that do not exceed \$50 million, and a "crowdfunding" exemption.

Following is a summary of the key provisions regarding Crowdfunding of the JOBS Act.

Crowdfunding

Title III, Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, or the "CROWDFUND Act," exempts from registration offers and sales of securities to the public that comply with new rules to be adopted by the SEC under new Section 4(6) of the Securities Act. The SEC is required to adjust the dollar amounts applicable to the crowdfunding exemption at least every five years to reflect any change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics.

Conditions to an Issuer's Reliance on the Exemption

To rely on the crowdfunding exemption, an issuer must satisfy the following conditions:

- The issuer must be a U.S. company that is not a reporting company or an investment company, or as otherwise determined by the SEC.
- The aggregate amount of securities sold by the issuer within the previous 12-month period, including in reliance upon the exemption, cannot exceed \$1 million.
- The aggregate amount of securities sold to any investor by the issuer pursuant to the crowdfunding exemption as well as any other sales by that issuer to the investor within the previous 12-month period cannot exceed the greater of \$2,000 or, based on a certification as to annual income provided by the investor,
 - 5% of such investor's annual income or net worth, if either the annual income or the net worth of the investor is less than \$100,000; and
 - 10% of such investor's annual income or net worth, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or greater than \$100,000.

- The offering must be conducted through a broker or funding portal that complies with new Section 4A(a) and the issuer must comply with new Section 4A(b), both described below.

Requirements Applicable to an Intermediary Participating in a Crowdfunding Offering

Section 4A(a) provides that a person that acts as an intermediary in an offering in reliance on Section 4(6) must do the following:

- Register with the SEC as a broker or a funding portal (as defined in new Section 3(a)(80) of the Exchange Act) and comply with any rules applicable to a funding portal that are adopted by the SEC.
- Register with any applicable self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act).
- Provide disclosures required by the SEC, including disclosures related to risks and other investor education materials.
- Ensure that each investor
 - reviews investor-education information, in accordance with SEC rules;
 - positively affirms that the investor understands that the investor is risking the loss of the entire investment and that the investor can bear such a loss; and
 - answers questions demonstrating an understanding of matters set forth in an SEC rule, including the level of risk generally applicable to investments in startups, emerging businesses, and small issuers, and an understanding of the risk of illiquidity.
- Take steps to reduce the risk of fraud with respect to such offerings, as established by SEC rule, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20% of the outstanding equity of every issuer whose securities are offered by such intermediary.
- Make available to the SEC and potential investors any information provided by the issuer pursuant to Section 4A(b), which is described below, not later than 21 days prior to the first day on which securities are sold to any investor (or such other period established by the SEC).
- Ensure that the offering proceeds are only provided to the issuer when at least the target offering amount is raised and that all investors are allowed to cancel their commitments to invest.
- Ensure that no investor exceeds the investment dollar limits discussed above.
- Protect the privacy of information collected from investors.
- Not compensate promoters, finders, or lead generators for providing personal identifying information of any potential investor.
- Prohibit its directors, officers, or partners from having any financial interest in an issuer using its services.
- Meet any other SEC requirements.

Disqualification from Crowdfunding Offerings

The JOBS Act requires the SEC to issue rules that disqualify issuers, brokers, and funding portals from participating in a crowdfunding offering under certain circumstances, including if any such person has been the subject of various types of SEC and other governmental actions.

Required Issuer Disclosures

Section 4A(b) provides that an issuer who offers or sells securities pursuant to the crowdfunding exemption must file with the SEC and provide to investors and the relevant broker or funding portal the following information:

- The name, legal status, physical address, and website address of the issuer.

- The names of the directors and officers and each person holding more than 20% of the shares of the issuer.
- A description of the business and the anticipated business plan of the issuer.
- A description of the financial condition of the issuer including, for offerings that, together with all other
- crowdfunding offerings within the preceding 12-month period have, in the aggregate
 - target offering amounts of \$100,000 or less, the income tax returns filed by the issuer for the most
 - recently completed year and the issuer's financial statements certified by the CEO to be true and complete in all material respects;
 - target offering amounts of more than \$100,000 but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC; and
 - target offering amounts of more than \$500,000, audited financial statements.
- A description of the stated purpose and intended use of the proceeds of the offering.
- The target offering amount, the deadline to reach that amount, and regular updates regarding the progress of the issuer in reaching that amount.
- The price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor is provided in writing the final price and all other required disclosures and given a reasonable opportunity to rescind the purchase commitment.
- A description of the ownership and capital structure of the issuer, including how the securities being offered are being valued and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions.
- Any other information required by the SEC.

After a crowdfunding offering, the issuer must file with the SEC not less than annually and provide to investors reports of the results of operations and financial statements of the issuer, as required by SEC rule.

Restrictions on the Crowdfunding Offering Process

An issuer must satisfy the following conditions when relying on the crowdfunding exemption:

- It must not advertise the terms of the offering, except for notices that direct investors to the broker or funding portal.
- It must not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking steps required by SEC rule to ensure that such person clearly discloses any receipt, past or prospective, of such compensation.
- It must comply with any other SEC requirements.

Provisions Applicable to Purchasers in a Crowdfunding Offering

A person who purchases a security in a crowdfunding offering:

- May bring an action against the issuer alleging material misstatements or omissions and seeking to recover the consideration paid with interest less the amount of any income received thereon or for damages if the person no longer owns the security; and
- May not transfer the securities during the one-year period beginning on the date of purchase except to the issuer or an accredited investor, in a registered offering, to a member of the family of the purchaser, in connection with the death or divorce of the purchaser, or as permitted by SEC rule.

Impact of Crowdfunding Offering on Exchange Act Registration

The JOBS Act provides that investors that acquire their securities in an offering conducted pursuant to the crowdfunding exemption in Section 4(6) will not be counted for purposes of determining whether the number of record holders of a company's equity securities triggers registration under Section 12(g) of the Exchange Act.

Impact on State Law

The JOBS Act provides that sales of securities pursuant to the crowdfunding exemption will not be subject to state law registration, documentation, or offering requirements and states will have jurisdiction with respect to fraud or deceit, or unlawful conduct by a broker, dealer, funding portal, or issuer in connection with a crowdfunding offering.

Exemption for \$50 Million Offerings

Title IV, Small Company Capital Formation, amends Section 3(b) of the Securities Act to authorize the SEC to adopt a rule that exempts from registration the offer and sale within the prior 12-month period in reliance on the exemption of no more than \$50 million (subject to increase every two years, if appropriate) of equity securities, debt securities, and debt securities that are convertible or exchangeable to equity interests, including any guarantees of such securities. The new rule will also permit issuers to solicit interest in the offering prior to filing any offering statement pursuant to specified terms and conditions. The SEC may impose other terms, conditions, or requirements on the use of the exemption, including:

- The need for the issuer to prepare and electronically file with the SEC and distribute to prospective investors an offering statement containing: (i) audited financial statements; (ii) a description of the issuer's business operations, its financial condition, its corporate governance principles, and its use of investor funds; and (iii) other appropriate matters; and
- Provisions under which the exemption will not be available.

The civil liability provision in Section 12(a)(2) will apply to any person offering or selling such securities.

The SEC must require issuers that rely on this new exemption to file audited financial statements with the SEC annually after the offering and the SEC may require the issuers to make available to investors and file with the SEC periodic disclosures.

Impact on State Law

The JOBS Act provides that sales of securities pursuant to the new \$50 million offering exemption will not be subject to state law registration, documentation, or offering requirements provided the securities are offered or sold on a nation states will retain jurisdiction with respect to fraud and deceit, or unlawful conduct by a broker or dealer, in connection with an offering under this exemption.

Contacts

Steven C. Cohen, Co-Chair, scohen@morganlewis.com, 609.919.6604

Thomas Kellerman, Co-Chair, tkellerman@morganlewis.com, 650.843.7550