

How Offerors Can Act Regarding the JOBS Act

a.k.a.: How real estate syndications, start-ups and other companies wanting to raise money (offerors/issuers) may want to act, based on the bill

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President Obama signed the “Jumpstart Our Business Startups Act” (the JOBS Act) on April 5, 2012. This bill will make it substantially easier for companies to raise money although key provisions do not take effect immediately. To look up information about the Act, use the phrase “Jumpstart Our Business Startups Act”, and not “JOBS Act”. The reason is that earlier Congress considered and passed other bills also called the “Jobs Act” and searching on the latter is liable to generate information on the wrong bill. (Be suspicious of anything with dates earlier than 2012 on it.) Two parts of the Act that will be important for companies using private placement offerings to raise money are the provisions allowing crowdfunding and the provisions relaxing restrictions on Rule 506 offerings. Neither will be available, though, until the Securities & Exchange Commission (SEC) issues regulations for both. The SEC has 90 days to issue the regulations for Rule 506 offerings and 270 days to issue regulations for the crowdfunding offerings.

The Rule 506 Provisions of the Act

The big change is that public advertising is allowed, although then all investors must be accredited investors – no non-accredited but sophisticated investors are allowed. (See Section 201(a)(1) and (b).) The relatively high requirements for an accredited investor remain the same.

Basically, an accredited investor is: 1) Any individual whose net worth, or joint net worth with his/her spouse, exceeds \$1,000,000 excluding the primary residence; or 2) Any individual who either had income in excess of \$200,000 in each of the two last years or joint income with his/her spouse in excess of \$300,000 in those years and is reasonably expected to have the same income level in the current year; or 3) Any organization with total assets in excess of \$5,000,000 not formed for the purpose of acquiring the investment; or 4) Any organization in which each of the owners is an accredited investor.

Companies will have to decide whether public advertising will be worth giving up sophisticated investors who are not accredited. Presumably there will be a large number of companies publicly advertising for accredited investors. That means that some companies may prefer not to advertise publicly and rely instead on personal connections in order to have both accredited and sophisticated investors. It also is not clear what restrictions the SEC will put on the advertising; it may, for example, decide to restrict advertising to the brief “tombstone” ads allowed in California 25102(n) offerings and Model Accredited Investor Exemption offerings.

The JOBS Act also allows those who are not licensed as securities brokers to maintain “a platform or mechanism that permits the offer, sale, purchase, or negotiation of ...securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means....” (Section 201(c).) Obviously this is designed to let Internet businesses provide lists of companies’ offerings, presumably for a fee. In addition, this may confirm the use of exchanges where securities of a company can be traded after they are originally issued even though those securities are not listed on an official stock exchange. It can make it easier for a company to sell securities if investors feel they have a way to sell their interests later.

Further, right now securities generally can only be sold by management of the offering company or persons licensed as securities brokers. The JOBS Act allows others (let’s call them “Affiliates”) to be involved as well. It does not, though, allow the use of “finders” (non-brokers who are compensated on a performance basis for bringing in investors) the way that a single-state offering may allow. (California law allows finders, for example.) These “Affiliates” may not receive “compensation in connection with the purchase or sale of such security” but may be compensated for “ancillary services” so long as they do not provide advice to the issuer or investors, do not negotiate the price of the securities and do not require the use of their own documents.

Of course, no one yet knows what the regulations that the SEC will adopt will look. Those regulations may have a substantial effect on the public advertising and “Affiliates” provisions.

Rule 506 – What to Do in the Interim

On Rule 506 offerings, offerors that need to raise money now and do not feel they need “public” advertising will want to proceed right away without waiting what is now the additional two and a half months. Those offerors will use their existing connections, contact those potential investors that the offeror reasonably believes are accredited or sophisticated, use “general” advertising and possibly use educational seminars along the same lines. “General advertising” in this sense roughly means advertising that explains what the offering company does but does not refer to any past, present or future offerings or provide any specifics on rates of return or purchase prices – and that is not primarily a sales piece. (Be sure to have an attorney review your materials before trying this, as it is a tricky area.)

For companies that need some form of advertising and need to raise money immediately, the California 25102(n) exemption and the Model Accredited Investor Exemption (MAIE) that approximately 30 states have adopted allow the use of a “tombstone” ad to briefly describe the offering and obtain accredited investors.

The New “Small Issues” (Section 401) Exemption

There is a new exemption in the JOBS Act that is much like the current Reg. A exemption. The problem is that, unlike with crowdfunding and the public advertising of Rule 506 offerings, this “Small Issues” (Section 401) exemption only preempts state law if either the securities are 1) offered or sold on a national securities exchange (which means going public) or 2) are sold only to “qualified purchasers.”

A “qualified purchaser” is defined as:

- a person with more than \$5 million in investment
- a company with more than \$5 million in investments owned by close family members
- a trust, not formed for the investment, with more than \$5 million in investments
- an investment manager with more than \$25 million under management
- a company with more than \$25 million of investments

That’s a much higher standard than “accredited investor”, which requires only \$1 million in net assets or \$200,000 in annual income (or \$300,000 in annual income with a spouse).

Outside of this, sales will only be able to be made in each state that passes its own legislation matching the other portions of the federal exemption. States frequently take a year or more to pass legislation. Also, as noted above, the history of states enacting legislation that enables federal exemptions is very poor. It would be great if many states quickly passed coordinated legislation, but that seems unlikely.

Crowdfunding — Generally

Up until now, crowdfunding could only be done legally by a company effectively pre-selling its goods or services at a discount. That does not mean the crowdfunding provisions go into effect immediately, though. The Act gives the Securities & Exchange Commission 270 days to issue regulations for the crowdfunding offerings. No crowdfunding can be done prior to the SEC issuing those regulations. Still, the Act is expected to open up crowdfunding for a number of smaller companies.

The crowdfunding exemption applies to issuers who do not sell more than \$1 million to investors under any exemption during any 12-month period. Companies that want to raise more than \$1 million in 12 months will not be able to use crowdfunding.

To summarize, the amounts investors may invest is limited by their income and net worth. The crowdfunding must be done through “Conduits” registered with the Securities & Exchange Commission (SEC). Issuers may not advertise except for notices which direct investors to the Conduit. Issuers must also file annual reports with the SEC. In terms of financial disclosures, offerings of less than \$100,000 in a year need only provide income-tax returns and financials certified by their CEO. With offerings between \$100,000 and \$500,000 in a year, the financials must be reviewed by a public accountant. For offerings between \$500,000 and \$1 million, the financials must be audited.

Crowdfunding — Investor Amount Restrictions

There are some restrictions on how much investors may invest. Investors who have either annual income of less than \$100,000 or whose net worth (presumably excluding the principal residence) is less than \$100,000 may only invest in any 12-month period the greater of \$2,000 or 5 percent of the investor's annual income or net worth. One thing companies using crowdfunding will need to consider is whether they want to set higher minimums for investment, given that the administrative time for a small investor is often as much as for a large investor. If \$1,000,000 were raised by having 500 people invest \$2,000 each, the administrative time per investor could be a substantial part of the \$2,000 contributed by each investor.

If either the annual income or net worth (again, presumably excluding the principal residence) of the investor is equal to or more than \$100,000, then the investor may invest 10 percent of the investor's annual income or net worth in any 12-month period, not to exceed a maximum amount of \$100,000.

(There is an inconsistency in the wording of the statute on these two categories. Presumably to fit within the second category the investor must have both income in excess of \$100,000 AND (not "or") net worth of more than \$100,000. Expect the SEC to address this in its regulations.)

Crowdfunding — Use of Registered Conduits Required

For better or worse, the transaction must be conducted through a licensed securities broker or funding portal (either of which we'll call a "Conduit") that has registered with the SEC for crowdfunding. The Conduit must also register with any self-regulatory organization that is applicable, such as FINRA. (There are non-brokers who are required to register with FINRA.) Part of the Conduit's duties are to: provide disclosures to investors related to risks; ensure that each investor reviews investor-education information; and confirm that the investor understands that the investor is risking the loss of the entire investment, that the investor could bear such a loss, that the investor understands the level of risk applicable to investments in startups, emerging businesses, and small issuers, and understands the risk of illiquidity.

The Conduit must also obtain a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered. In addition the Conduit must ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest. (There are other requirements as well.)

Crowdfunding — Actions Required of Issuers

Issuers using crowdfunding have requirements to meet also. The issuer is required to make a filing with the SEC.

Further, an issuer using the crowdfunding exemption may not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker, and not less than annually file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer. This is unusual in that most private placement offerings do not require annual filings with the SEC.

Crowdfunding — Non-Financial Disclosures

In terms of non-financial disclosures to investors, the issuer must provide, among other things: a) the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer; and b) the anticipated business plan of the issuer. There's not much surprise there.

The issuer must also disclose, among other things, 1) the target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount; and 2) a description of the ownership and capital structure of the issuer. The later must include, in addition to other matters, (a) the terms of the securities of the issuer being offered and each other class of security of the issuer; (b) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered; and (c) 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.

Crowdfunding — Financial Disclosures

The financial description requirements depend on the amount being raised. For offerings that, together with all other crowdfunding offerings of the issuer within the preceding 12-month period, total \$100,000 or less the issuer must provide: (i) the income tax returns filed by the issuer for the most recently completed year, if any, and (ii) financial statements of the issuer, which must be certified by the principal executive officer of the issuer to be true and complete in all material respects (but which do not need to be audited).

Where the current offering plus other crowdfunding offerings by the issuer total more than \$100,000 but less than \$500,000, the issuer must provide financial statements reviewed (but not audited) by a public accountant who is independent of the issuer.

When the total of the current offering and the crowdfunding offerings within the last 12 months total more than \$500,000, audited financial statements are required. Given the expense of audited financial statements and the \$1,000,000 limit on offerings, some issuers may decide not to take the crowdfunding approach.

Crowdfunding — Preemption of State Law

Thankfully, the crowdfunding provisions appear to preempt state law regarding state registration, documentation, and offering requirements. The provisions still allow the states to take enforcement actions. States are allowed to require notice filings (as is done with Rule 506 offerings) but not to charge filing fees. (Section 305.)

Much will depend on the regulations the SEC issues.

The JOBS Act preempts state securities laws regarding the public advertising of Rule 506 offerings and also crowdfunding. This bright spot is crucial because in the past, where the federal government has not preempted state law, the states have either not passed their own laws allowing use of the exemption or have added conditions that made the exemption unworkable. This is what occurred with the Rule 504, Rule 505 and Reg. A exemptions and why often they are not used.

The SEC is required to issue the regulations within 90 days for the public advertising of Rule 506 offerings and 270 days for crowdfunding. The deadlines are based on the signing date of the bill, which was April 5, 2012. Presumably the SEC will issue its proposed regulations substantially before those deadlines, but we do not know when. On the other hand, given the SEC's hostility to the JOBS Act, the final regulations are not expected to be approved until about the time of the deadlines, though one can always hope.

Crowdfunding — Some Observations

With respect to crowdfunding, it probably will be almost nine months before crowdfunding is allowed. (Crowdfunding is currently not legal except for offerors taking money in exchange solely for discounted prices on future goods or services.) In addition, certain provisions of the JOBS Act may make crowdfunding unappealing to many offerors.

First, any crowdfunding offering(s) by an offeror that total more than \$500,000 in any 12-month period will require audited financials, which are expensive. With a Rule 506 offering, audited financials are not required unless the offering is trying to raise more than \$7.5 million. Even then, audited financials are not required if the issuer cannot, in its opinion, obtain them "without unreasonable effort or expense." With public advertising becoming available for Rule 506 offerings, many companies may decide that a Rule 506 offering is preferable, especially if they do not want to deal with investors that are neither accredited nor sophisticated. (Investors who are not sophisticated frequently take more time to deal with on an ongoing basis, as they often do not understand business and investing fundamentals.)

Second, a crowdfunding transaction must be conducted through a licensed securities broker or a funding portal (either of which we'll call a "Conduit") that has registered with the SEC for crowdfunding. In addition, an issuer using the crowdfunding exemption may

not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker. Some offerors may not want this type of restriction. Further a crowdfunding issuer must annually file with the SEC reports of the results of operations and financial statements of the issuer. This is unusual for private placement offerings and some issuers may not want this filing requirement.

Third, the Conduit must also obtain a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity. Some existing investors may not appreciate that. In addition the Conduit must ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest prior to that point. Presumably that means that the offeror will have to provide proof to the Conduit that the total target offering amount is in an escrow account and get the Conduit's approval before the money is released to the offeror. Some offerings may not find that appealing either.

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