

THE JOBS ACT OF 2012

On Thursday, April 5, 2012 (on the eve of both Good Friday AND Passover, whether or not any religious significance was intended [or even recognized]) the President signed into law HR 3606, the "Jumpstart Our Business Startups Act" (or "JOBS Act") as public law 112-106. The JOBS Act was enacted with substantial bi-partisan support in both Houses of Congress (a unique event in this election year) at the behest of an unlikely coalition of Democrat legislators willing to allow a grace period for smaller concerns before the full weight of Federal regulations affecting public companies takes effect and of pro-business Republicans seeking to allow more start-up companies to tap public capital markets.

As reported in The Wall Street Journal, efforts were led by a private sector task force headed by the outgoing chairman of the National Venture Capital Association, who is also a Democratic campaign donor. The task force showed Congress that young companies on average spent \$2.5 million in legal and compliance costs to go public and another \$1.5 million a year after that. The task force also showed that over 90% of the jobs created by start-ups occur AFTER the companies go public. The proposals resulted in legislation that includes: (a) a "regulatory on-ramp" for "emerging growth companies" ("EGC's"); (b) more freedom to speak to investors about EGC's; (c) up to five years for EGC's before the full public company regulations apply; (d) redefining what a public company is by changing the number of shareholders that triggers the application of the Security Exchange Act of 1934, with special calculations for small banks and bank holding companies (which are already subject to substantial bank regulations); (e) substantial increases in the amount of capital that can be raised in Regulation A and certain other small offerings, along with expanded opportunity to "test the water" and market the offering; (f) a new type of non broker-dealer called a "funding portal"; and (g) creating a new type of small capital raising known as "crowdfunding."

The Purposes of the JOBS Act

The JOBS Act is intended to stimulate the growth of the American economy by helping smaller and emerging growth companies gain access to U.S. capital markets. It is also intended to reduce some of the regulatory burdens on smaller and emerging growth companies that elect to raise capital in US markets. The JOBS Act also provides a permissible new way to raise smaller amounts of capital without regulatory oversight. Finally, the JOBS Act opens new opportunities including a new doorway for broker-dealers and other persons involved in raising capital for issuers.

What the JOBS Act Does Legislatively

The JOBS Act amends provisions of the Securities Act 1933 (as previously amended, the "1933 Act"), the Securities Exchange Act of 1934 (as previously amended, the "1934 Act"), parts of the



reworking of the 1933 Act and 1934 Act wrought by the Sarbanes-Oxley Act of 2002 (the “SOX Act”) and parts of the Investment Company Act of 1940, as amended (the “1940 Act”).

What is a “Public Company”?

A. “Regular” Companies

Under the law before April 5, 2012 (which continues until the United States Securities and Exchange Commission (“SEC”) adopts implementing regulations), a company with at least \$3 million in assets and 500 shareholders had to register with the SEC under the 1934 Act. The JOBS Act changes those triggers to:

- at least \$10 million in assets;
- at least 2000 shareholders (or at least 500 non-accredited investors), where accredited investors are seen as persons who can bear a higher amount of risk. Exhibit A to this Alert sets out the details of who or what is an “accredited investor”;
- shareholders pursuant to an employee compensation plan are excluded from the number of total shareholders for these purposes; and
- shareholders who acquire shares in crowdfunding transactions (see the discussion below under Crowdfunding) are not counted as shareholders for 1934 Act registration purposes.

These changes are effective immediately but require the SEC to adopt implementing regulations. The JOBS Act does not set a time frame for SEC action.

- These revisions provide greater flexibility to issuers; they can have larger and more diverse shareholder bases without triggering public reporting requirements.
- Elimination of the 500 shareholder head count paranoia, where employees have not received equity-based compensation for fear of hitting the 500 shareholder trigger and/or shareholder death or marriage raised the risks of inadvertent violation of the 1934 Act’s registration requirements.

On the other hand, these changes (once effective) will require broker-dealers to continue to check both with respect to whether a transaction could cause an issuer to become subject to the 1934 Act registration requirements and, if so, whether the broker-dealers may effect security transactions where 1934 Act information is not publically available.

B. Small Banks and Bank Holding Companies

The JOBS Act changes the 1934 Act triggers for banks and bank holding companies. No 1934 Act registration as a public company will be required until the bank or bank holding company has at least 2000 shareholders (up from 500) and at least \$10 million (up from \$3 million) in assets. A bank or bank holding company which is currently registered under the 1934 Act may deregister if it has fewer than 1200 (changed from 300) shareholders. The SEC is required by the JOBS Act to adopt implementing regulations by April 5, 2013.



“Emerging Growth Companies”

Under the JOBS Act an issuer with total annual revenues of less than \$1 billion (indexed for inflation every 5 years using the Consumer Price Index for All Urban Consumers, the “CPI”) will continue to be an EGC for the earlier to occur of 5 years after the first public offering of its equity securities or on the last day of the fiscal year on which its gross annual revenues exceed \$1 billion (again, as indexed). EGC’s are exempt from various disclosure and internal control requirements, including those added by the SOX Act (and especially the auditor attestation report under Section 404 on the adequacy of the issuer’s internal controls over its financial reporting system). Some of the other salient exemptions are: (a) reduction in the scope of financial information required in an IPO registration statement and waiver of any financial information of Management Discussion and Analysis for any fiscal period prior to the earliest audited period presented in the IPO, and (b) scaled-back executive compensation disclosure. In addition, the SEC is required to submit a report to Congress by November 1, 2012 (180 days after April 5, 2012) setting forth specific recommendations to streamline the registration process for EGC’s, after analyzing how Regulation S-K “can be updated to modernize and simplify the negotiation process and reduce the costs and other burdens associated with ... [Regulation S-K’s] requirements for issuers who are... [EGC’s].”

In addition the JOBS Act relaxes the restrictions (newly codified in Section 15D of the 1934 Act as a result of the SOX Act) applicable to security and research reports. The JOBS Act provides:

- an EGC or “any person authorized to act on behalf of an EGC” (which may include a broker-dealer or other capital finder) shall be permitted to use oral and written communications with two types of investors, qualified institutional buyers (“QIB’s”) or institutions that are accredited investors (but not individuals see Exhibit A), before a registration statement is filed with the SEC in order to assess investor interest. This can be seen as a major expansion of the “testing the waters” initiative the SEC adopted in 1992 (SEC Rule 254) in connection with a revision of Regulation A;
- broker-dealers and other market participants may publish and distribute research reports about EGC’s without those reports being deemed “offers” for purposes of the 1933 Act, whether published and distributed before a registration statement is filed with the SEC or once the underwriting process begins; the exemption applies even if a broker-dealer is a participant in the selling group underlying an offering of EGC securities;
- neither the SEC nor FINRA (the Financial Industry Regulatory Authority) may have a rule which would restrict a research analyst from participating in meetings with management of an EGC in connection with its IPO;
- neither the SEC nor FINRA may prohibit a broker-dealer from publishing or distributing a research report or making a public appearance in connection with an EGC within any prescribed time period following an IPO of the EGC; and
- broker-dealers may accept the relaxed disclosure requirements for the IPO of an EGC, but may also insist on obtaining additional information as part of the broker-dealer’s due diligence.



The EGC provisions of the JOBS Act took effect on April 5, 2012.

Regulation A Offerings

The JOBS Act increases, once the SEC adopts implementing regulations (no time frame is established in the JOBS Act), the amount that can be raised under Regulation A (and other “smaller issue” offerings) from \$5 million to \$50 million in any 12-month period. The JOBS Act sets forth substantial terms and conditions similar to existing Regulation A which are to be reflected in the SEC implementing rule. But if those terms and conditions are met, the offering is exempt from registration with the SEC so long as:

- only equity securities, debt securities or convertible debt securities are involved;
- a copy of the offering statement is filed with the SEC; and
- the issuer files audited financials annually with the SEC.

The JOBS Act requires that the SEC rules permit an issuer to solicit interest in the offering prior to filing an offering statement with the SEC AND provides that the securities sold will not be “restricted securities” under the Federal securities laws. The SEC can (but does not have to): (a) impose disqualification provisions which would bar issuers from using this method, and (b) require an issuer to make periodic disclosures to the SEC and investors. Securities sold pursuant to the rule are “covered securities” for purposes of Section 18 of the 1933 Act (a concept introduced by the National Securities Markets Improvement Act of 1986), such that they are exempt from State registration requirements so long as they are sold on either a national securities exchange (which may be an electronic exchange recognized under Section 6 of the 1934 Act) or to “qualified purchasers” as defined by the SEC.

In connection with these revisions to the Federal securities laws, the Comptroller General of the United States is mandated to conduct a study of the impact of State securities laws regulating offerings and report to Congress no later than July 5, 2012.

- These changes, especially including the “covered security” designation, may make Regulation A an attractive alternative to registration.
- The new SEC rule will not change the existing negligence standard for liability under Section 12 of the 1933 Act (inclusion of a material misstatement or omission in the offering material even if no intent to defraud) in offerings.

Marketing Private Offerings

The JOBS Act, as noted above, eases the ability of an issuer to access the capital markets. In the area of private placements, the JOBS Act ELIMINATES the long-standing prohibition on general solicitation and general advertising with respect to offerings under Rule 506 of Regulation D, so long as all purchasers are accredited investors (see Exhibit A). Receipt of the solicitation or advertisement by a non-accredited investor does not destroy the exemption, so long as that



recipient is not allowed to purchase a security in the offering. The SEC is directed by the JOBS Act to revise its rules not later than July 5, 2012 to reflect this change. This revision to Rule 506 is not limited to EGC's; rather it applies to ALL types of issuers seeking to rely on Rule 506. The new SEC Rule will make clear that Rule 506 offerings will not be considered "public offerings" for purposes of other provisions of the Federal securities laws.

Of particular relevance for broker-dealers are the following:

- a broker-dealer will no longer have to show a "pre-existing relationship" with an investor before the broker-dealer may offer a security in a private placement to that investor although the broker-dealer will remain subject to its obligation to determine the suitability of the investment for that investor and, more generally, will remain subject to all of the antifraud proscriptions under the securities laws; and
- the JOBS Act directs that the new SEC rules require issuers to verify that purchasers are accredited investors ("using such methods as determined" by the SEC). It is not clear what, if any, (and if some, how much), responsibility a broker-dealer will have to verify a purchaser's accredited investor status.

The JOBS Act permits a person to "maintain a platform or mechanism that permits the offer, sale, purchase or negotiation of or with respect to 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" WITHOUT having to register with the SEC as a broker-dealer. This provision appears to validate and enable platforms such as SecondMarket (formerly Restricted Stock Partners). The JOBS Act provision further permits the person maintaining the platform (or any associated person) to co-invest in those securities and also to provide "ancillary services" including providing due diligence services and standardized documents to issuers and/or investors, so long as the platform does not mandate the use of the platform's documents. The platform person cannot: (a) receive transaction-based compensation, (b) have possession of customer funds or securities; and/or (c) be subject to a "bad boy" provisions (statutory disqualification under Section 3[a] [39] of the 1934 Act).

Enhanced Liquidity for Restricted Securities

The JOBS Act eliminates the prohibition on general solicitation and advertisement that has applied to the resale of restricted securities acquired in reliance on SEC Rule 144A. So long as the seller reasonably believes the offerees of a Rule 144A offering are QIB's, the Act permits all forms of solicitation and advertising. The JOBS Act requires the SEC to amend Rule 144A by July 5, 2012, to implement the provisions.

Note that the JOBS Act does not address FINRA advertising rules. Generally communications used in Rule 144A transactions are seen as "institutional sales material" in light of the otherwise applicable prohibition on general solicitation. If a broker-dealer will be involved in the sale or resale of Rule 144A securities and wishes to advertise, then more generally, the broker-dealer will



wish to see what, if any, clarifying guidance is given by FINRA in light of the JOBS Act mandated revisions to Rule 144A.

Funding Portals

The JOBS Act adds a new Section to the 1934 Act for “funding portals.” Under this new Section, a funding portal may not: (a) offer investment advice; (b) solicit purchases, sales or offers to purchase securities displayed on the portal; (c) compensate employees, agents or other persons for solicitation of or based on the sale of securities displayed on the portal; (d) hold, manage or possess investor funds or securities; or (e) engage in other activities which the SEC by rule determines inappropriate. The JOBS Act amends the 1934 Act to require the SEC to adopt within 270 days of April 5, 2012 (*i.e.* December 31, 2012) rules implementing the funding portal provisions. Funding portals under the SEC rules will be exempt from registration requirements for broker-dealers so long as: (a) the funding portal is a member of a national securities association registered under Section 15A of the Act (*e.g.* FINRA); (b) is subject to SEC examination enforcement and rulemaking authority; and (c) is subject to other requirements that the SEC, by rule, reasonably imposes. In the case of funding portals to be used in connection with “crowdfunding” transactions (discussed in this Alert under the heading “Crowdfunding”) an intermediary is required to act as the portal and to register as such with the SEC.

An intermediary acting as the funding portal for crowdfunding transactions must satisfy certain broker-dealer requirements and an SRO (self-regulatory organization, such as FINRA) membership requirements. The intermediary must also provide SEC-mandated disclosures to each investor to ensure that the investor: (a) reviews SEC-approved investor education information; (b) “positively affirms” that the investor understands the risk of losing his or her entire investment; (c) answers questions showing an understanding of the risk involved in the investment (*i.e.* start ups, emerging business and/or small issuers); and (d) understands liquidity risks and other matters the SEC rules shall require. In addition the intermediary must:

- obtain a background and securities enforcement regulatory history on each officer, director and person holding 20% of the equity ownership of an issuer;
- furnish specified disclosure about the issuer and the offering to each investor at least 21 days prior to the first sale;
- ensure that offering proceeds are released to the issuer only when the aggregate amount of capital raised is equal to or greater than the announced target offering amount;
- allow investors to cancel a commitment to invest prior to the date of providing proceeds to the issuer; and
- take steps to protect the privacy of investor information.

The intermediary is also responsible to “make efforts” to ensure that no investor in any 12-month period purchases securities in crowdfunding transactions from all issuers that exceed the statutory permitted limit for that investor. An intermediary is prohibited from compensating “promoters, finders, or legal generators” who provide personal information about any potential



investor. No intermediary or its principals may have any financial interest in an issuer using the intermediary's services. The JOBS Act imposes Section 12 liability on an issuer (*i.e.* the negligence standard without the need to show fraudulent intent) for any material misstatement or omission in any communication (oral or written) in connection with a crowdfunding transaction (note that "issuer" for this purposes includes "any person who offers or sells" a security, notionally encompassing the broker-dealer or intermediary handling the transaction).

The SEC is required by the JOBS Act within 270 days of April 5, 2012 (*i.e.* December 31, 2012) to establish disqualification provisions which will make a broker-dealer or funding portal ineligible to participate in crowdfunding transactions. The JOBS Act also bars the State securities regulators from taking any enforcement or "other administrative action" against a registered funding portal, except that the State regulator where the funding portal has its principal place of business retains examination and enforcement authority so long as the State law is "not in addition to or different from the requirements" of the SEC. State securities regulators retain parallel jurisdiction over funding portals with respect to fraud.

"Crowdfunding"

The JOBS Act adds a new exemption to the registration requirements of the 1933 Act allowing an issuer to sell up to \$1 million of securities without registering with the SEC. "Crowdfunding" is an interesting acronym derived from the words Capital Raising Online While Deterring Fraud and Unethical Non Disclosure, which reflects its Internet-oriented Silicon Valley origins. Crowdfunding under the JOBS Act is not, however, limited to start-ups or early stage concerns. It may be used to raise capital for any domestic company without SEC registration, provided it meets the JOBS Act requirements.

Crowdfunding transactions must be effected through a registered broker-dealer or through an intermediary registered as a funding portal. An issuer cannot advertise the terms of the offering except to give notice directing potential investors to the broker-dealer or to the intermediary. The significant registration and operational requirements to become an intermediary functioning as a funding portal are discussed above under the heading "Funding Portals."

Under the crowdfunding exemption from registration no investor may invest more than (a) the greater of \$2000 or 5% of the investor's annual income or net worth (but not both) if either is less than \$100,000 and (b) 10% of the investor's annual income or net worth (but not both), but not more than \$100,000, if the investor's annual income or net worth is more than \$100,000. These dollar limits on individual investor participation in crowdfunding transactions are to be adjusted at least every five years to reflect changes in the Consumer Price Index. The calculations of income and net worth are to be done the same way as the SEC calculates those amounts to determine if a person is an accredited investor (see Exhibit A attached)

The issuer in a crowdfunding transaction cannot compensate any person to promote its offering through communications provided by a broker-dealer or a funding portal unless the issuer complies with the SEC rule requirements to disclose the compensation payments to investors. The issuer must also file with the SEC a copy of all disclosure materials used. Securities issued in



crowdfunding transactions are restricted securities. Generally shares purchased in a crowdfunding transaction cannot be transferred for one year from the date of purchase. There are exceptions for transfer to the issuer or to an accredited investor or a sale in a registered public offering. As noted in the discussions under the heading "Funding Portals" above, a broker-dealer or funding portal in a crowdfunding transaction must take particular steps to assure the suitability of the investment for an investor AND to make certain the investor understands the risks involved in such an investment. Investors in crowdfunding transactions are NOT counted as shareholders for purposes of the number of shareholders which would trigger the registration requirement as a public company under the 1934 Act.

Crowdfunding transactions may only involve securities of issuers: (a) which are organized under the laws of a State or territory (such as Guam) of the United States or the District of Columbia; or (b) which are public companies reporting under the 1934 Act; or (c) which are mutual funds registered with the SEC or a private fund exempt from registration under the Investment Company Act of 1940; or (d) which are permitted by SEC Rule.

The JOBS Act requires that the SEC adopt implementing rules for crowdfunding transactions within 270 days of April 5, 2012 (*i.e.* December 31, 2012). In that connection the SEC is instructed to consult with the State securities regulators when designing those rules.

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Accredited Investors

Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. The Act provides companies with a number of exemptions. For some of the exemptions, such as rules [505](#) and [506](#) of [Regulation D](#), a company may sell its securities to what are known as "accredited investors."

The federal securities laws define the term accredited investor in [Rule 501 of Regulation D](#) as:

1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
3. a charitable organization, corporation, or partnership with assets exceeding \$5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person;
7. a natural person with income exceeding \$200,000 in each of the two 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; or
8. a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

For more information about the SEC's registration requirements and common exemptions, read our brochure, [Q&A: Small Business & the SEC](#).

<http://www.sec.gov/answers/accred.htm>

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