

How Offerors Can Act Regarding the JOBS Act

In the prior two pieces I discussed how the “Jumpstart Our Business Startups Act” (the JOBS Act) requires the Securities & Exchange Commission (SEC) to adopt new regulations to allow public advertising of Rule 506 offerings and to allow crowdfunding. This article discusses how real-estate syndications, start-ups and other companies wanting to raise money (offerors/issuers) may want to act based on the bill.

One bright spot is that the JOBS Act preempts state securities laws regarding the public advertising of Rule 506 offerings and also crowdfunding. This 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’s 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.

Rule 506 and Related Offerings

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.

Crowdfunding

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, the 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.

The New “Small Issues” (Section 401) Exemption

One item not addressed previously is the 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” means:

- a person with more than \$5 million in investments
- 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 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.

Finally, 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.)

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