SUTHERLAND

LEGAL ALERT

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Impact of the Jumpstart Our Business Startups Act (the JOBS Act) on Broker-Dealers

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the JOBS Act or the Act),[1] which is intended to stimulate economic growth by helping smaller and emerging growth companies access the U.S. capital markets. The JOBS Act amends various provisions of, and adds new sections to, the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act), as well as provisions of the Sarbanes-Oxley Act of 2002. While the JOBS Act is focused on easing regulatory requirements for issuers, the Act also is likely to impact broker-dealers involved in raising capital for these issuers.

Emerging Growth Companies

The JOBS Act relaxes provisions of the federal securities laws pertaining to public offerings and public companies considered to be "emerging growth companies." An emerging growth company generally means an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. (§ 101) Such a company qualifies for exemptions from various disclosure and internal control requirements, particularly those added by the Sarbanes-Oxley Act of 2002, that would otherwise apply to it when registering an issue of securities. The JOBS Act also permits an emerging growth company to submit a draft registration statement to the U.S. Securities and Exchange Commission (SEC) staff for confidential nonpublic review and conduct a road show before any filings are made, so long as a registration statement is filed with the SEC not more than 21 days after the issuer conducts a road show. (§ 106)

In addition, the JOBS Act relaxes restrictions codified in Section 15D of the 1934 Act applicable to securities analysts and research reports when the analysts provide research on emerging growth companies.[2] Key considerations for broker-dealers are noted below.

- **Pre-Filing Offers.** The JOBS Act permits an emerging growth company or "any person authorized to act on behalf" of an emerging growth company – presumably including a broker-dealer – to engage in oral and written communications with potential investors that are "qualified institutional buyers," or institutions that are accredited investors, before a registration statement is filed with the SEC, to ascertain investor interest. (§ 105) This change is effected via an amendment to Section 5 of the 1933 Act.

- **Pre-Filing Research Reports for Emerging Growth Companies.** The JOBS Act permits broker-dealers to publish and distribute research reports about emerging growth companies without the reports being deemed to be "offers" as defined in Section 2(a)(3) of the 1933 Act. This new "exclusion" from the definition of offers will apply even if the broker-dealer publishing and distributing the research report is participating in an offering of securities by the emerging growth company. It also will apply to research reports published and distributed before a registration statement is filed with the SEC.

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[1] JOBS Act, H.R. 3606, 112th Cong. (2012).

[2] The restrictions codified in Section 15D were added to the 1934 Act as part of the Sarbanes-Oxley Act of 2002 to impose conflict-of-interest restrictions on securities analysts and research reports.

- **Research Analyst Access to Emerging Growth Companies.** The JOBS Act explicitly prohibits the SEC and the Financial Industry Regulatory Authority (FINRA) from adopting or maintaining any rule in connection with an initial public offering by an emerging growth company that would restrict a research analyst from participating, alongside other associated persons of a broker-dealer, in meetings and communications with the management of an emerging growth company. These changes are reflected primarily in amendments to Section 15D of the 1934 Act.

- **Post-Offering Research Reports and Public Appearances.** The JOBS Act also explicitly prohibits the SEC and FINRA from adopting or maintaining any rule prohibiting a broker-dealer from publishing or distributing a research report or making public appearances within any prescribed period of time following the initial public offering date for the securities of an emerging growth company.

- **Due Diligence Considerations.** In carrying out due diligence on offerings for emerging growth companies, broker-dealers may want to consider the more relaxed disclosure requirements for such companies. In this regard, it should be noted that emerging growth companies can choose to forego the exemption and instead comply with the requirements that apply to an issuer that is not an emerging growth company.

- **Implementation.** The changes to the federal securities laws relating to emerging growth companies take effect immediately.

Regulation A Offerings

The JOBS Act increases the ceiling for "small issues" offerings, such as "Regulation A" offerings, under the 1933 Act from $5 million to $50 million (aggregated during a 12-month period). (§ 401) In particular, the Act requires the SEC to adopt a rule exempting from registration a class of securities where the offering amount of all securities offered and sold within the prior 12-month period does not exceed $50 million. The Act prescribes extensive terms and conditions to be reflected in the SEC rule (many of which are modeled on the current provisions of Regulation A): the exemption will apply only to equity securities, debt securities or debt securities convertible or exchangeable to equity securities; an offering statement must be filed with the SEC and distributed to investors; and the issuer must file audited financial statements with the SEC annually.

The rule must also permit the issuer to solicit interest in the offering prior to filing any offering statement with the SEC and provide that the securities will not be considered to be "restricted securities" within the meaning of the federal securities laws. The SEC is also authorized to impose disqualification requirements and to require an issuer to make periodic disclosures to the SEC and investors. Finally, the JOBS Act amends the 1933 Act to designate securities offered and sold pursuant to the rule as "covered securities" for purposes of Section 18 of the 1933 Act if the securities are offered and sold on a national securities exchange or to "qualified purchasers," as defined by the SEC with respect to that purchase or sale. Key considerations for broker-dealers are noted below.

- **Regulation A Alternative to IPO?** The JOBS Act materially increases the ceiling for "small issue" offerings, raising the prospect that smaller initial public offerings may be conducted in reliance on the exemptive rule to be adopted by the SEC. This alternative may become particularly attractive if the offering will qualify as "covered securities" under state blue sky laws.

- **Seller Liability.** Broker-dealers participating in an offering in reliance on the rule to be adopted by the SEC should be aware that the Act imposes Section 12(a)(2) liability on persons who offer

or sell securities in these offerings. Under this section of the 1933 Act, a person who offers or sells a security by means of a prospectus or oral communication that includes a material untruth or omission will be liable for such untruth or omission unless the person can sustain a due diligence defense.

- **Implementation.** The SEC must adopt a rule to implement these provisions of the JOBS Act. The Act does not establish a time frame for the adoption of the rule.

Private Offerings

The JOBS Act eliminates the long-standing prohibition on general solicitation and general advertising that has applied to private offerings conducted in reliance on Rule 506 of Regulation D under the 1933 Act, so long as all purchasers are accredited investors. (§ 201) The Act directs the SEC to revise its rules not later than 90 days after enactment (i.e., July 3, 2012) to reflect this change. Significantly, this change to Rule 506 is not restricted to small or emerging growth companies, but rather applies to all types of issuers seeking to rely on Rule 506. In this respect, the Act clarifies that offers and sales complying with Rule 506 as it is to be revised will not be deemed public offerings for purposes of other provisions of the federal securities laws. Key considerations for broker-dealers are noted below.

- **No Need for Pre-Existing Relationship with Investors in Private Offerings.** By virtue of lifting the prohibition, a broker-dealer will not have to demonstrate a "pre-existing relationship" with an investor before a broker-dealer offers a private placement to the investor.

- **Responsibility for Accredited Investor Determination.** The Act specifies that the SEC's rule change to Rule 506 is to require issuers to take reasonable steps to verify that purchasers are accredited investors, "using such methods as determined" by the SEC. The Act does not directly address the role that broker-dealers might play in connection with verifying the accredited investor status of purchasers. The required SEC rulemaking may address the broker-dealers' role.

- **Broker-Dealer Exemption for Private Placement Platforms.** The Act appears to provide an exemption from broker-dealer registration for a person who maintains a platform or mechanism that facilitates private placements.[3] In particular, the exemption would apply to a platform or mechanism that permits the offer, sale, purchase or negotiation of, or with respect to, securities. It would also apply to a platform or mechanism that permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person or through other means. Significantly, this exemption permits the person maintaining the platform or an associated person to co-invest in the securities or provide "ancillary services" with respect to the securities without losing the exemption. "Ancillary services" are defined as the provision of certain "due diligence" services or standardized documents to issuers and investors, so long as the person does not negotiate the terms of the documents, and issuers are not required to use the standardized documents. The Act imposes several critical conditions on a person seeking to rely on the exemption: the person cannot receive transaction-based compensation, cannot have possession of customer funds or securities and cannot be subject to a statutory disqualification, as defined in Section 3(a)(39) of the 1934 Act.

[3] The Act appears to incorrectly cite to broker-dealer registration pursuant to Section 15(a)(1) of the 1933 Act, rather than Section 15(a)(1) of the 1934 Act. We anticipate that this error will be remedied by a correcting amendment or other action at a later date.

- **Implementation.** The Act requires the SEC to amend Rule 506 within 90 days after enactment to remove the prohibition on general advertising and solicitation. However, the exemption for private placement platforms appears to be effective immediately.

Resales of Restricted Securities Among Institutional Buyers

The JOBS Act eliminates the prohibition on general solicitations and advertisements that has applied to resale of restricted securities made in reliance on Rule 144A under the 1933 Act. (§ 201) So long as the seller reasonably believes the purchasers of Rule 144A offerings are qualified institutional buyers, the Act permits all forms of general advertising and general solicitation. Key considerations for broker-dealers are noted below.

- **Treatment of Communications Under FINRA Rules.** The Act does not reference SEC or FINRA advertising rules. Generally, communications previously used in connection with Rule 144A transactions would likely have been considered "institutional sales material" under FINRA rules given the prohibition on general solicitation. If broker-dealers want to advertise Rule 144A transactions to a broader audience, consideration should be given to whether the communications continue to qualify as institutional sales material under FINRA rules.

- **Implementation.** The Act requires the SEC to amend Rule 144A within 90 days after enactment to implement the Act's provisions.

Crowdfunding

The JOBS Act adds a new exemption to Section 4 of the 1933 Act – Section 4(6) – for an issuer to publicly offer and sell up to $1 million of securities through "crowdfunding"[4] transactions without registering the securities with the SEC. (§ 302) The crowdfunding rules are intended to increase access to capital markets for businesses, especially entrepreneurs and developing companies. Significantly, the transactions must be effected through a registered broker-dealer or funding portal (discussed below), and the issuer cannot advertise the terms of the offering except for notices which direct investors to the intermediary. Further, an issuer cannot compensate any person to promote its offerings through communication channels provided by the intermediary without taking the steps to be prescribed by the SEC rule to ensure that the person clearly discloses the compensation. In addition, the issuer must file disclosure material with the SEC. Securities issued in a crowdfunding transaction must be treated as restricted securities. Under the new exemption, no individual investor may invest more than (1) the greater of $2,000 or 5% of the investor's annual income or net worth, if either is less than $100,000, and (2) 10% of the investor's annual income or net worth (not to exceed a maximum aggregate amount sold of $100,000), if either is equal to or more than $100,000. Key considerations for broker-dealers are noted below.

- **As Crowdfunding Intermediary.** The JOBS Act imposes significant responsibilities on the broker-dealer or funding portal acting as the intermediary for the crowdfunding transactions. In addition to satisfying broker-dealer registration and self-regulatory organization (SRO) membership requirements (discussed below), the intermediary is required to provide SEC-

[4] Crowdfunding, otherwise known as Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure, is a method of raising capital, usually via the Internet, to support developing companies. Crowdfunding, however, is not limited to developing companies, and may be used by any company seeking to raise capital without registering with the SEC, provided the company satisfies the requirements of the JOBS Act.

required disclosures to each investor to 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 answers questions demonstrating an understanding of the level of risk generally applicable to startups, emerging business and small issuers; and understands liquidity risks and other matters as the SEC determines to be appropriate by rule. In addition, the intermediary must take measures to reduce the risk of fraud, as established by SEC rule, including the following:

- Obtaining a background and securities enforcement regulatory history on each officer, director and person holding more than 20% of the outstanding securities of the issuer whose securities are being offered;
- Furnishing specified disclosure information to each investor not later than 21 days prior to the first day on which sales are made;
- Ensuring that all offering proceeds are provided to the issuer only when the aggregate capital raised is equal to or greater than the target offering amount, and allow investors to cancel their commitments; and
- Taking steps to protect the privacy of information collected from investors.

- **Aggregating All Investor Crowdfunding Transactions.** Significantly, the Act requires the intermediary to "make efforts," as the SEC determines appropriate by rule, to ensure that no investor in a 12-month period has purchased securities in crowdfunding transactions that, in the aggregate, from all issuers, exceed the investment limits applicable to that investor.

- **No Finders' Fees.** The Act prohibits an intermediary for a crowdfunding transaction from compensating "promoters, finders or lead generators" for providing the intermediary with the personal identifying information of any potential investor.

- **No Financial Interest in Issuer.** The Act requires an intermediary for a crowdfunding transaction to prohibit its directors, officers or partners (or any person with a similar status or performing a similar function) from having any financial interest in the issuer using its services.

- **Liability as Issuer.** The Act imposes Section 12 liability on an issuer for any material misstatement or omission in any written or oral communication used in connection with a crowdfunding transaction. Significantly, the term "issuer," for purposes of the liability provision, includes "any person who offers or sells" a security in a Section 4(6) transaction.

- **Implementation.** The JOBS Act requires the SEC to adopt rules no later than 270 days after the enactment of the Act to implement the crowdfunding transactions. The Act also requires the SEC to establish disqualification rules under which an issuer and a broker-dealer or funding portal will not be able to participate in crowdfunding transactions pursuant to new Section 4(6) of the 1933 Act.

Alternative Broker-Dealer – Funding Portals

The JOBS Act adds a new registration category to the 1934 Act for "funding portals." Funding portals are referenced in the new provisions for crowdfunding. (§ 304) However, the provisions added to the 1934 Act for funding portals do not appear to limit the activities of funding portals to crowdfunding situations. As defined pursuant to a new section added to the 1934 Act, a "funding portal" does not (1) offer investment advice or recommendations, (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal, (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal, (4) hold,

manage, possess or otherwise handle investor funds or securities, or (5) engage in such other activities as the SEC, by rule, determines appropriate.

- **Registration.** The JOBS Act contains seemingly conflicting provisions regarding the registration requirements for funding portals. The new provisions for crowdfunding transactions added to the 1933 Act by the JOBS Act require an intermediary for the transactions to be registered as funding portals. However, the JOBS Act also amends the 1934 Act to require the SEC to adopt a rule exempting funding portals from broker-dealer registration requirements, provided that the funding portal (1) remains a member of a national securities association properly registered under Section 15A of the 1934 Act, (2) remains subject to SEC examination, enforcement and other rulemaking authority, and (3) is subject to other requirements that the SEC, by rule, determines appropriate.

- **Implementation.** The Act requires the SEC to establish rules implementing the funding portal provisions within 270 days after the enactment of the JOBS Act.

Shareholder Caps for Public Company Reporting

The JOBS Act increases the shareholder thresholds that trigger public company reporting requirements. Under the Act, the investor threshold under Section 12(g) of the 1934 Act increases from 500 "holders of record" to 2,000 before the public reporting obligations apply. (§ 501) More specifically, the Act provides that no registration is required until the issuer has a class of equity securities held of record by either 2,000 persons *or* 500 non-accredited investors. In determining whether an issuer must register a security with the SEC, the Act provides that shareholders pursuant to an employee compensation plan are excluded from the calculation of total shareholders. (§ 502) Unlike other provisions of the Act, the shareholder cap rules apply to all companies and not just emerging or small companies.

- **Issuer Flexibility.** Issuers of securities now have considerable flexibility to develop much larger pools of shareholders before triggering public reporting requirements and filing an initial public offering. This added flexibility should enhance an issuer's ability to attract a larger and more diverse shareholder base.

- **Relief from 1934 Act Registration for Crowdfunding Transactions.** The Act authorizes the SEC to adopt a rule exempting securities issued in connection with crowdfunding transactions from the securities registration requirements imposed by Section 12(g) of the 1934 Act. (Section 12(g) requires an issuer to register its securities with the SEC once they are held by 500 or more security holders.) (§ 303)

- **Implementation.** The SEC must adopt a rule to implement these provisions of the JOBS Act. The Act does not establish a time frame for the adoption of the rule. The Act does provide that the SEC will revise the definition of "held of record" pursuant to Section 12(g)(5) of the 1934 Act and will adopt safe harbor provisions designed to make it easier for issuers to determine if the holders of their securities received the security in connection with an employee compensation plan. However, no time frame is given for either of these two rulemaking clarifications. Finally, the Act provides that, within 120 days of the enactment of the Act, the SEC will examine its authority to enforce Rule 12g5-1 and determine if new enforcement tools are needed in light of the Act.

These changes, once effective, may raise challenges for broker-dealers, both with respect to verifying whether investors to whom shares are sold could cause an issuer to lose the 1934 Act exemption, as well as with respect to effecting transactions in securities of a potentially larger pool of issuers for which 1934 Act required information is not publicly available.

What's Next?

Although the SEC has not yet adopted any rules implementing any of the provisions of the JOBS Act, the SEC has published a notice that it will be accepting public comments before issuing rulemaking proposals.[5]

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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[5] See "SEC Seeks Public Comment Prior to JOBS Act Rulemaking."