Client Alert.

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The JOBS Act: Opportunities and Risks for Broker-Dealers

By Hillel Cohn

In April 2012, President Obama signed the Jumpstart Our Business Startups Act (the JOBS Act) into law. The Act focuses upon stimulating economic growth by making it easier for smaller businesses to raise capital. Among the measures included in the JOBS Act are a number of provisions creating new opportunities for broker-dealers. Such measures include:

- Facilitating initial public offerings by emerging growth companies (less than $1 billion of annual gross revenues);
- Increasing the ceiling for exempt public offerings under Regulation A to $50 million;
- Permitting use of general solicitation and advertising in private placements under Rule 506 if the purchasers in the private placement are all accredited investors; and
- Allowing companies to raise up to $1 million through crowdfunding.[1]

PUBLIC OFFERINGS BY EMERGING GROWTH COMPANIES

The JOBS Act facilitates public offerings by emerging growth companies by, among other things:

- Permitting pre-filing communications with institutional investors to gauge their potential interest;
- Permitting the publication of research reports about an emerging growth company that is conducting a public offering of its common equity securities;
- Permitting a registration statement for an IPO to be filed on a confidential basis;
- Relaxing restrictions on research analysts' participation in discussions with IPO underwriting clients;
- Prohibiting timing restrictions on distribution of post-IPO research reports and public appearances by research analysts; and
- Paring back certain disclosure requirements for emerging growth companies.

Certainly the prospect of more public offerings by emerging growth companies presents attractive opportunities for broker-dealers. Indeed, a significant majority of companies likely to consider an IPO will qualify as emerging growth companies and the opportunity for pre-filing communications with institutional investors and more robust research should result in an enhanced IPO process. It is not clear if the liberalized rules on post-IPO research reports and analyst involvement with IPOs will apply to follow on offerings by emerging growth companies. On April 27, 2012, SIFMA wrote to FINRA urging revisions to the FINRA rule governing research reports[2] to effectively extend such provisions of the JOBS Act to any public offering by an emerging growth company.

[1] MoFo Client Alert, The JOBS Act: http://www.mofo.com/files/Uploads/Images/120326-The-JOBS-Act.pdf.

[2] See NASD Rule 2711 and NYSE Rule 472.

Of course, new opportunities are accompanied by new risks. There is nothing in the JOBS Act which eliminates the obligation of broker-dealers to disclose material conflicts and certain other matters which could impair the integrity of research reports. Restrictions on research analyst compensation and the prohibition on promising favorable research remain in place. Nor is there any relaxation of the requirements of Regulation AC, an SEC rule intended to ensure that research reports reflect the author's views. The fact that research reports regarding an emerging growth company will not be considered "offers" and therefore may be distributed prior to or during a public offering by such companies, does not eliminate the risk that such reports fail to meet FINRA standards for customer communications (NASD Rule 2210) or that such reports run afoul of SEC Rule 10b-5.

Thus, with the unwinding of certain restrictions on analysts and research reports, broker-dealers will need to enforce measures to prevent reoccurrence of the very abuses which led to the restrictions in the first place. In this regard, investment banks will be well-served to rigorously maintain the independence of their research function and their compliance personnel should remain alert for any actions that might compromise such independence. Written supervisory procedures should be updated to address conduct that had been previously prohibited, such as the publication of research reports during an IPO. Broker-dealers may eliminate or modify restrictions on research reports and public appearances by research analysts during the "quiet period" imposed on selling group members by NASD Rule 2711 (40 days following the IPO for managers; 25 days for other underwriters and selling group members, with a further quiet period for managers covering the period from 15 days before through 15 days after the expiration, termination, or waiver of any lockup). Restrictions on analyst communications with investment banking clients and related chaperoning requirements may be modified. Information barriers should be reviewed, although consideration should be given to the importance of maintaining the independence of research personnel when modifying information barriers. It would be prudent for broker-dealers to accompany liberalized rules with enhanced scrutiny of communications with research personnel and stepped up testing of supervisory procedures intended to prevent improper influences on a firm's research department.

EXEMPT OFFERINGS UP TO $50 MILLION

The exemption for small public offerings provided by Regulation A had largely fallen into disuse given its $5 million cap. There may be renewed interest in Regulation A offerings given the increase in the cap to $50 million. While private placements often raise far more than $50 million in transactions under Regulation D's Rule 506, securities issued in Regulation A offerings are unrestricted and may be freely resold by the purchasers. Therefore, institutions that have limitations or concerns with respect to holding restricted securities may participate in Regulation A offerings, and the securities sold may not be subject to an illiquidity discount comparable to the discount associated with many private placements.

Increased interest in Regulation A offerings could generate new business for investment bankers, particularly those who work with smaller companies. However, broker-dealers will need to bear in mind that the liability provisions of Section 12(a)(2) of the Securities Act of 1933 will apply to Regulation A offerings. Under this provision, brokers can be held liable for material misstatements and omissions in the sales process, even if the misstatements result from good faith mistakes rather than any intention to deceive. The principal defense against a Section 12(a)(2) action is the due diligence defense: the broker must prove that it did not know the statement was untrue or misleading and, in the exercise of reasonable care, could not have known. Companies seeking to raise funds through Regulation A may be less mature than companies undertaking a full IPO. Their internal controls may be less reliable and their financial reporting may be less rigorous. Under these circumstances, broker-dealers participating in Regulation A offerings will want to proceed with care and will

likely impose the same diligence requirements and comfort letter procedures that they would employ in undertaking a fully registered public offering.

REGULATION D OFFERINGS AND PRIVATE PLACEMENT PLATFORMS

While private placements under Rule 506 of Regulation D have long been a popular method for raising significant amounts of money, the ability to seek investors through general solicitation may significantly expand use of Rule 506 as a means of raising capital. Historically, companies have raised substantial funds from institutional investors in Rule 506 offerings, often relying on established relationships between such institutions and the issuer's placement agent to avoid Regulation D's prohibition on use of advertising and general solicitation to find investors. Elimination of the prohibition on general solicitation will likely result in Rule 506 offerings targeting a broader spectrum of potential investors. While some companies may undertake such offerings on their own, the SEC's prohibition on paying issuer employees for selling securities[3] may result in many issuers working through broker-dealers when undertaking a Rule 506 offering.

General solicitation and advertising is only permitted if all of the ultimate purchasers in the private placement are accredited investors. The JOBS Act directs the SEC to adopt rules implementing this provision. Such rules must include requirements for the issuer to take "reasonable steps" to verify that the purchasers are in fact accredited investors. It is not clear if the SEC will determine that the widely accepted practice of obtaining detailed representations from the prospective investors will suffice as "reasonable steps" to verify accredited investor status. Once the SEC rules are released, broker-dealers participating in Rule 506 private placements will need to ensure their understanding of the verification requirements.

While the verification obligation falls on the issuer, a failure to meet this obligation would likely result in the purported private placement being deemed an unregistered public offering in violation of Section 5 of the Securities Act of 1933. In order to avoid the potential liabilities and reputational damage associated with selling securities in violation of Section 5, broker-dealers participating in Rule 506 offerings that employ general solicitation should independently evaluate the adequacy of steps taken by the issuer to verify accredited investor status. Some broker-dealers may prefer to prepare their own template for such verification efforts and require its use as a condition of the broker-dealer participating in the private placement.

Broker-dealers participating in a general solicitation with respect to a Rule 506 offering will also need to consider whether their conduct complies with FINRA requirements governing communications with the public. General solicitation materials will most likely constitute sales literature under NASD Rule 2210[4] and, depending on the method of dissemination, may also constitute an advertisement under the same rule. Broker-dealers will need to ensure that use of general solicitation materials complies with the approval, record keeping and content standards set forth in Rule 2210. The contents of any general solicitation materials will also need to be reviewed in order to determine if they could be construed as a "recommendation" to purchase the subject securities. Under applicable case law and regulatory requirements, a broker-dealer may not recommend an investment unless the broker-dealer has a reasonable basis to determine that the recommended investment is suitable for the investor.[5] "Recommendation" has been broadly construed to include a "suggestion" that a customer take action. See FINRA Notice to Members 11-02 for a discussion of what constitutes a recommendation. The fact that a general solicitation by its nature is not tailored to any individual customer argues against

[3] See SEC Rule 3a4-1 promulgated under the Securities Exchange act of 1934.

[4] To be replaced by FINRA Rule 2210.

[5] *See*, *e.g.*, *SEC v. Hanley*, 415 F. 2d 589 (2d. Cir. 1969), FINRA Rule 2111 and FINRA Notice to Members 10-22.

a conclusion that the communication constitutes a recommendation. Nonetheless, broker-dealers should review the contents of any general solicitation materials to ensure that no portion could be construed as a recommendation.

The JOBS Act includes a provision which may impact the role of broker-dealers in Rule 506 offerings. The Act provides that certain platforms which are intended to facilitate private placements need not register as broker-dealers. Such platforms may provide an Internet portal or other mechanism facilitating the offer and sale of securities in a Rule 506 transaction. In addition, the platforms may provide certain ancillary services such as conducting diligence or providing standardized deal documents. In order to avoid broker-dealer registration, neither the platform nor its associated persons may be compensated based on the sale of securities, nor may they receive separate compensation for investment advice. In addition, they may not hold customer funds or securities and none of their associated persons may be subject to statutory disqualification as defined in Section 3(a)(39) of the Securities Exchange Act of 1934.

The JOBS Act provision on Rule 506 platforms represents to some extent a codification of SEC no action letters on matching systems. In this regard, the SEC Staff has historically considered whether or not the matching system receives transaction-based or contingent compensation, provides advice, participates in negotiations, or handles customer funds and securities in determining if the matching system must register as a broker-dealer.[6] In its analysis, the SEC has consistently emphasized the centrality of transaction-based compensation as a key factor in determining whether or not a matching system would need to register as a broker-dealer. The JOBS Act provision requires that the Rule 506 platform and associated persons receive "no compensation in connection with the purchase or sale" of a security. This language appears to be consistent with the SEC Staff's broad interpretation of transaction-based compensation and encompasses any fee linked to securities transactions, even if the fee is not calculated as a percentage of the value of the securities transactions. Thus, even an "items processed" fee may run afoul of the prohibition and Rule 506 platforms will likely need to utilize subscription fees, membership fees, and other forms of compensation that are not linked to actual securities transactions.

It should be noted that the JOBS Act does not include a provision pre-empting state law with respect to broker-dealer registration as it may relate to private placement platforms. Thus, any Rule 506 platform, particularly one which facilitates transactions with retail investors, will need to consider whether the nature of its operations might trigger the broker-dealer registration requirements in the states where it operates.

CROWDFUNDING

The JOBS Act permits private companies to raise up to $1 million in a 12-month period through crowdfunding. Securities sold in such transactions will be deemed restricted securities. In order to qualify for this exemption, the transaction must be effected through an intermediary, who may be a registered broker-dealer or a "funding portal." Issuers, as well as any person who offers or sells securities in a crowdfunding transaction, are subject to potential liability based on the Section 12(a)(2) standards discussed above.

A "funding portal" is a new legal category for intermediaries added by the JOBS Act. Funding portals must register with the SEC, but are not subject to the full regulatory scheme applicable to registered broker-dealers. Funding portals must also be members of a national securities association; at this time it is not clear if FINRA will establish a membership category for funding portals or if a new national securities association will be formed for funding portals. The JOBS Act pre-empts state regulation of funding portals.

[6] *See*, *e.g.*, Progressive Technology, Inc., 2000 WL 1508655 (Oct. 11, 2000); Stock Power, Inc., 1998 WL 423019 (July 24, 1998); Angel Capital Electronic Network, 1996 WL 636094 (Oct. 25, 1996).

A funding portal is defined in the JOBS Act as any person acting as an intermediary in a crowdfunding transaction who:

- Does not offer investment advice or recommendations;
- Does not solicit the purchase or sale of securities;
- Does not compensate its employees based on the sale of securities;
- Does not hold customer funds or securities; and
- Does not engage in such other activity as the SEC may by rule prohibit.

A funding portal, like a Rule 506 platform, cannot be paid for providing investment advice or effecting transactions in securities. In addition, the funding portal may not pay others to refer potential investors. Thus, there are rather significant constraints on the business model for funding portals.

Under the JOBS Act, all intermediaries in crowdfunding transactions, whether or not registered as broker-dealers, are required to discharge significant duties, including:

- Providing disclosure to prospective investors regarding the risks of investment and such other matters as the SEC might deem appropriate;
- Ensuring that each investor
    - Reviews investor education materials as the SEC deems appropriate,
    - Affirms his understanding of the risk of total loss,
    - Answers questions demonstrating an understanding of the risks of investing in startups,
    - Answers questions demonstrating an understanding of the risks of illiquid investments, and
    - Answers questions demonstrating an understanding of such other matters as the SEC might deem appropriate;
- Taking measures to reduce the risk of fraud, including conducting background checks on the managers of the issuer;
- Ensuring that offering proceeds are not released to the issuer until the minimum offering requirements have been met;
- Making such efforts as the SEC may deem appropriate to ascertain if the investors in the crowdfunding are complying with the maximum limitations on their investments in such opportunities; and
- Protecting the privacy of customer information.

Note the inherent difficulty in some of these tasks, such as "ensuring" that investors have reviewed appropriate investor education materials. In addition, efforts to ascertain if investors have complied with the limitations on the maximum amount which they may invest will be complicated by the fact that such limitations vary based upon an investor's income and net worth and investors often fail to update such information.[7] Consider also the costs involved in "reducing the risk of fraud" by the issuer and discharging the other obligations of intermediaries.

[7] The maximum amount which an investor may purchase through crowdfunding transactions in any 12-month period shall not exceed: (i) the greater of $2000 or 5% of the investor's net worth or annual income if either the net worth or annual income is less than $100,000, or (ii) 10% of the investor's net worth or annual income if either the net worth or annual income is greater than $100,000.

Given the $1 million limit for crowdfunding transactions and the significant responsibilities imposed on intermediaries, it is not at all clear that broker-dealers or funding portals will find this to be an attractive business opportunity. Even if the intermediary pre-qualifies a pool of prospective investors, maintaining up to date information on such investors and monitoring their total investment in crowdfunding transactions, some of which may be effected through other intermediaries, will not be simple.

The prospects may be particularly problematic for funding portals. Under the JOBS Act, they have the same obligations as broker-dealers when acting as intermediaries for crowdfunding transactions. This will require them to retain and train personnel who can conduct diligence on issuers, manage a disclosure process, and obtain current information about prospective investors. Compliance and legal personnel will likely be essential for a funding portal to carry out its statutory obligations. Moreover, funding portals will be subject to an as-yet-undetermined regulatory regime to be imposed by the SEC and a national securities association and will be exposed to investor claims to the extent they offer and sell securities by means of any false or misleading statements. Given the prohibition on receipt of transaction-based compensation, it may be difficult for funding portals to develop an economically viable model for servicing crowdfunding transactions.

Much may depend upon the SEC regulations governing the obligations of intermediaries in crowdfunding transactions. However, it was in part a result of lobbying by the SEC that significant obligations were imposed on intermediaries in crowdfunding transactions. As a result, it is unlikely the SEC will adopt rules which materially reduce the potential compliance burden for crowdfunding intermediaries. Considering the costs of such compliance, it may be difficult to find reputable firms willing to participate in crowdfunding transactions as intermediaries.

Contact:

Hillel T. Cohn
(213) 892-5251
hcohn@mofo.com

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