

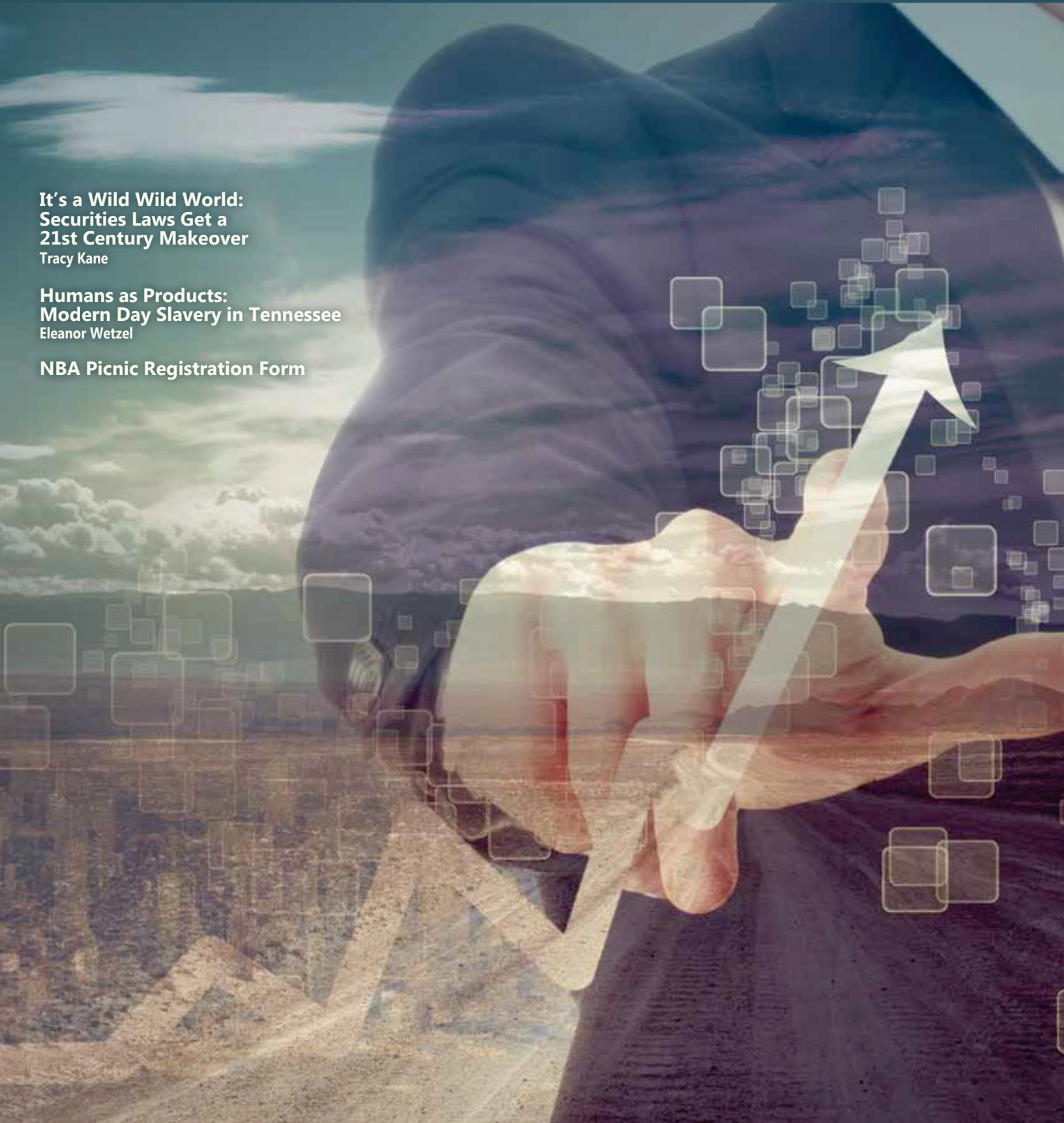
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**It's a Wild Wild World:
Securities Laws Get a
21st Century Makeover**
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It's a Wild Wild World: Securities Laws Get a 21st Century Makeover

by: Tracy Kane

The financial crisis that struck in 2008, and the Great Recession that followed created an economic and political environment that spurred congressional action that, on the one hand, attempted to impose new regulations to rein in certain opaque and largely unregulated areas of capital markets (Frank-Dodd), and, on the other, hand relax regulations to make it easier for smaller and emerging companies to access capital markets (the JOBS Act).

Layered around these “events” was the accelerating pace of technological innovation that has been changing everything from the way people and businesses communicate with each other to the way businesses start-up and operate. New industries that didn't exist a decade ago are disrupting established industries and forcing these established industries to either adapt or become extinct. And just as in the time of Gutenberg Press, advances in the methods and speed with which people are able to communicate with each other today is changing the landscape, socially, politically and economically.

With the backdrop of a changing and disruptive economic environment, the financial crisis and Great Recession created the right set of circumstances for legislative and regulatory change for businesses and the capital markets. The word “crisis” in Chinese is the combination of two characters, 危 (wēi), meaning danger, and 机 (jī), meaning opportunity, conveying the meaning that in a crisis you cannot continue the status quo; you must act and, in so doing, something will change. The choice is yours, however, to seize the opportunity to make change for the better.

We certainly have change upon us in the area of securities laws and regulations, but it is yet to be determined whether the changes will be for the better for issuers and/or investors, not to mention all the other players in U.S. capital markets. The various statutory and rule changes are too vast to cover in this article, so I will focus principally on the changes with respect to private offerings, which represent

the greatest number of securities transactions each year and within that, principally the changes under the JOBS Act eliminating the prohibition on the general solicitation and general advertising in “private” offerings¹ and establishing a framework for allowing un-accredited investors in large numbers to invest in privately offered securities through web-based crowdfunding platforms.

This article focuses mainly on the new rules and guidance related to early-stage private offerings, which, of course, with the elimination of the prohibition on general solicitation and general advertising for “private” offerings are really not so private anymore.

I. JOBS Act Background

The Jumpstart Our Business Startups (JOBS) Act, enacted in April 2012, was a bipartisan effort promoted by both Congress and the White House as a way for small and high-growth businesses to raise capital more efficiently and, as a consequence, create more jobs. The sentiment behind the Act was to reduce the regulatory burdens imposed by existing securities laws on relatively small companies so that they can raise capital less expensively and from more sources.

The key components of the JOBS Act are: (1) creation of a new category of company, “emerging growth companies” (EGCs) and providing them with certain accommodations in the initial public offering (IPO) process and subsequent reporting obligations (*Title I*); (2) relaxation of communication restrictions in private offerings (*Title II*); (3) creation of a new exemption allowing companies to utilize crowdfunding platforms to raise capital (*Title III*); (4) expanding the scope of

the exemptions from registration under Section 3(b) of the Securities Act (*Title IV*); and (5) raising the trigger for when a company becomes subject to registration and reporting requirements under Section 12(g) of the Exchange Act (*Title V and VI*).

Under the JOBS Act, the Commission was directed to adopt rules, on a rather aggressive timeline, implementing these various provisions. While none of the rulemaking timelines were met timely, the Commission has finally released several proposed rules and at least one final rule, along with issuing other relevant guidance within the last year.

II. Status of Commission Rulemaking

A. General Solicitation and Advertising in private placements

Section 201(a)(1) of the JOBS Act directs the Commission to remove the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506 of Regulation D (i.e., offerings of an unlimited amount solely to accredited investors, or not more than 35 unaccredited investors), provided that sales are limited to accredited investors and an issuer takes reasonable steps to verify that all purchasers of the securities are accredited investors.²

The new rule, a new Rule 506(c) of Regulation D, released on July 10, 2013 and not effective until 60-days after release, permits issuers relying on Rule 506 to use general solicitation and advertising to offer their securities if the issuer takes “reasonable steps” to verify that the investors are accredited investors and that all purchasers are “accredited investors” or the issuer reasonably believes that the investors are accredited investors at the time of the sale of the securities. Under the final rule, the determination of the reasonableness of the steps taken to verify an accredited investor is an objective assessment by an issuer based on the facts and circumstances of

each purchaser, however, the final rule also provides a non-exclusive list of methods, essentially a safe harbor provision, issuers may use to satisfy the verification requirement. The methods include reviewing copies of any IRS form that reports the income of the purchaser and obtaining a written representation that the purchaser will likely continue to earn the necessary income in the current year and receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that the issuer has taken reasonable steps to verify the purchaser’s accredited status.

For issuers wishing to use general solicitation and advertising to offer their securities, the issuer must file a Form D, the notice that issuers must file with the Commission when they sell securities under Regulation D, but the issuer will now check a new box that has been added to Form D for issuers claiming the new Rule 506 exemption permitting general solicitation and advertising.

Also under the final rule, securities sold pursuant to Rule 144A can be offered to persons other than QIBs (“Qualified Institutional Buyers”, which is defined by Rule 144A(a)(1),³ including by means of general solicitation, provided that the securities are sold only to persons whom the seller and any person acting on behalf of the seller reasonably believe to be QIBs.

At the time the Commission issued the new final rules implementing the new JOBS Act exemption, the Commission also proposed new amendments to current private offering rules, including changes to filing deadlines, disqualifying issuers who fail to file Form D, requiring issuers to provide additional information about the issuer and the offering, and disclosure requirements for written general solicitation materials among others. These proposals are subject to a 60-day public comment period, so stay tuned!

B. Crowdfunding

The JOBS Act sought to introduce a way to harness the enthusiasm surrounding crowdfunding platforms, like kickstarter.com or IndiGoGo.com, which currently exist in the non-securities context. The goal was to allow private companies to get investment from “non-wealthy” individuals in a relatively low-risk manner.

Crowdfunding has its roots in sites like Kickstarter (www.kickstarter.com), a social networking site that helped artists, musicians, filmmakers and other creative people to finance their projects. The original founders of these sites saw the power of social media to source the crowd, whether that be knowledge on Wikipedia or real-time information on Twitter, and developed a way for creative types to source the crowd for money to get their projects off the ground. These platforms allow numerous, small investors to donate to projects they find through the site. Before the JOBS Act, crowdfunding for business ventures was limited, as the sale of securities triggered prohibitively expensive registration requirements and operators of crowdfunding sites might have been subject to regulation as brokers. To avoid the characterization as sales of securities, companies like Kickstarter facilitate rewards or the pre-purchase of products in exchange for funding of projects.

The popularity of these sites has proliferated with the number of projects, increasing from 1,454 in 2009 to over 28,000 in 2012, although only about 44% of the projects launched in 2012 met or exceeded their funding goal (note that projects that receive pledges, but that do not meet the funding goal do not get funded and the pledges are never consummated).⁴ The average contribution to a project on Kickstarter.com, for example, is \$25.⁵ These dollars, however, add up to significant capital flowing into creative endeavor.

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ors. In 2012 alone, over \$200 million was pledged to crowdfunded projects.⁶ Today, there are crowdfunding sites for just about anything and everything, from music and film/video projects, manufacturing projects, pet/animal initiatives, artisan craft projects, cheese-making, art projects, and tech start-ups among others.

The JOBS Act officially amended Section 4 of the Securities Act by adding a new Section 4(6) and created a new Section 4A to the Securities Act. The new Section 4(6) will allow most⁷ private companies in the U.S. to raise up to \$1 million over a 12-month period in small amounts to a large number of investors that are not accredited⁸ through crowdfunding platforms, referred to as “funding portals,”⁹ that are exempt from broker-dealer registration, but subject to the authority of the Commission and the funding portal must be a member of a national securities association.¹⁰ The \$1 million limitation applies to the aggregate amount of all securities sold by the issuer, whether of the same class or a different class (and possibly any restricted stock sold to employees), over the preceding 12 months.

The amount sold to an individual investor is limited based on the investor's annual income and net worth. For an investor with an annual income or net worth of less than \$100,000, the investor's maximum aggregate annual investment in securities issued under the crowdfunding exemption of the JOBS Act over a 12-month period is capped at the greater of \$2,000 or 5% of such investor's annual income or net worth. For investors with an annual income or net worth of greater than \$100,000, such investments are capped at the lesser of \$100,000 or 10% of such investors' annual income or net worth.¹¹ Securities sold under this crowdfunding exemption will be subject to a one-year transfer restriction, except in limited circumstances such as transferring the securities back to the issuer or to an accredited investor.

Securities acquired pursuant to the crowdfunding provisions will also be exempt from qualification under state blue sky laws. However, the provisions preserve state enforcement authority over unlawful conduct by issuers and intermediaries (funding portals) and with respect to fraud or deceit. Despite this, the North American Securities Administrators Association and its member states continue to be concerned about investor protection under the JOBS Act and the new rulemaking taking place to implement the Act.

Other limitations on the use of crowdfunding will apply, as to be determined by the Commission. The Commission has not yet issued proposed rules and has reminded issuers in a Notice that the JOBS Act requires the Commission to adopt rules to implement the new crowdfunding exemption and until then, any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws. The Commission has been meeting with industry groups, like CFIRA (Crowdfund Intermediary Regulatory Association),¹² and other interested parties as part of its information gathering process in preparation for issuing proposed, and ultimately, final rules. Until the Commission issues final rules, however, issuers may not rely on this new exemption.

Depending on the platform(s) utilized, the crowdfunding provisions of the JOBS Act may or may not be helpful to start-up entrepreneurs. For companies looking to raise less than \$500,000, crowdfunding will likely be a useful option. However, a company saddled with a plethora of small, inexperienced investors may find it difficult to attract the next round of investors later.

III. A Few Other Developments ... Commission Guidance Related to New Industry Practices

With the current unavailability of the new crowdfunding exemption, many issuers

have started to rely on another provision of the JOBS Act that previously received little attention — Title II (Section 4(b)) of the JOBS Act, which created a new exemption for broker-dealers operating on web-based platforms that provide certain services in the context of Rule 506 Reg D offerings

These new platforms are essentially online matchmakers connecting issuers of offerings pursuant to Rule 506 to accredited investors. These sites got a boost and regulatory legitimacy in March of this year when the Commission released two No Action letters confirming that a company registered as an investment advisor operating an internet-based platform exclusively available to accredited investors may offer and sell securities sold in compliance with Rule 506 without registering as a broker-dealer so long as the company does not receive transaction-based compensation, e.g., 5% of total value of securities sold, instead the company would receive compensation equal to a portion of the increase in value of the investment calculated at the termination of the investment, also known as “carried interest.”¹³ ■



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(Endnotes)

¹ For a more in depth discussion of the history and background of private offerings and the policy impact of the elimination of the prohibition on general solicitation and general advertising, I might be so bold as to recommend reading my previous article “Securities for Sale! Read All About it! The Private World of Private Offerings May Not Be So Private” that was published in the November issue of the *Nashville Bar Journal*.

² 17 CFR Parts 230, 239 & 242, Commission Release No. 33-9415 and No. 34-69959, No. IA-3624, July 10, 2013.

³ 17 CFR 230.144(a)(1).

⁴ See *Kickstarter.com, Kickstarter Stats* (Aug. 2013), <http://www.kickstarter.com/help/stats?ref=footer>.

⁵ <http://www.kickstarter.com/blog/trends-in-pricing-and-duration> (last updated Aug. 23, 2013).

⁶ Henry McCracken, *The Kickstarter Economy*, TIME (Oct. 1, 2012).

⁷ Use of the Section 4(6) exemption is not available to investment companies, foreign companies, issuers already reporting pursuant to Section 13 or Section 15(d) of the Securities Act, and other companies that the Commission determines appropriate are ineligible to use this exemption.

⁸ Rule 501 of Regulation D defines an “accredited investor” as, among other things, 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; 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 a business in which all the equity owners are accredited investors.

⁹ “Funding Portal” is a newly defined entity that, among other things, does not “solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal” or “offer investment advice or recommendations.”

¹⁰ Title III of the JOBS Act adds a new Section 3(h) to the Exchange Act, which requires the Commission to exempt, conditionally or unconditionally, an intermediary operating a funding portal from the requirement to register with the SEC as a broker; provided that the intermediary register with the Commission as a funding portal and be subject to the Commission’s examination, enforcement, and rulemaking authority. The funding portal also must become a member of a national securities association that is registered under Section 15A of the Exchange Act.

¹¹ The income and net worth of an investor are to be calculated the same way income and net worth are calculated under Rule 501 of Regulation D for “accredited investors.”

¹² CFIRA’s stated goal is to agree upon a standard set of principles as well as explore the development of a robust industry regulator. The group plans to create principles to establish an Investor’s Bill of Rights, ensure confidentiality of investors’ personal financial information, implement standardized reporting and communication among platforms, develop a code of conduct for crowdfunding platforms and create a recognizable brand common to trustworthy intermediaries similar to VeriSign or BBB, among others.

¹³ See No Action Letter Re: Angellist, LLC and Angellist Advisors, LLC, Mar. 28, 2013; see also No Action Letter Re: FundersClub, Inc. and FundersClub Management, LLC, Mar. 26, 2013.

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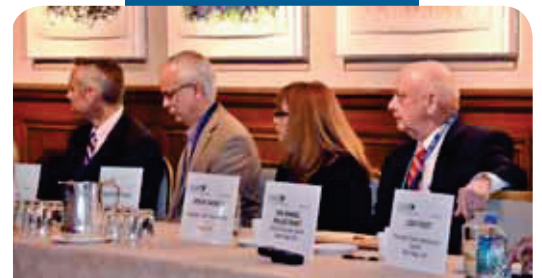
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