Caveat Venditor: Raising capital under the JOBS Act provisions

*By Michael J. Dayton**

There has been much ado lately about the Jumpstart our Business Startups Act (JOBS Act) of 2012, and rightfully so.

With the JOBS Act, which was signed into law about a year ago, Congress took some arguably radical steps to lessen the costs and regulatory burden on relatively smaller companies when raising capital. Two of the JOBS Act provisions — creating a "crowdfunding" exemption and eliminating the general solicitation prohibition in certain private placements — have the potential of significantly increasing capital raising efforts in Iowa. From the looks of it, entrepreneurs are very excited to be able to use these funding mechanisms, especially crowdfunding.

However, business owners and start-ups should be careful in utilizing these new JOBS Act provisions.

The crowdfunding exemption and the elimination of the general solicitation prohibition are not yet effective (as of the time of writing this article in early April). *Offering or selling securities at this time under the crowdfunding provisions of the JOBS Act or through general solicitation or advertising in a Regulation D offering, absent another applicable exemption, is unlawful under federal securities laws.*

Congress directed the Securities and Exchange Commission (SEC) to adopt or amend regulations to effectuate these provisions, and the SEC has yet to do so. It appears at this time that the crowdfunding rules may not be available until late in 2013 or even in 2014. The SEC proposed rule amendments last August to eliminate the general solicitation prohibition, but those rules have not been adopted.

In addition, regardless of the manner in which a security is offered and sold, the greatest exposure to the issuer is for material misstatements and omissions made during the offering process. The potential liability is exacerbated under the JOBS Act provisions, at least with respect to crowdfunding, because of the breadth of the offers and the mis-reliance issuers will place on the "crowdfunding intermediary" (as discussed below). Properly drafted private placement memoranda or other required offering documents that include carefully tailored risk factors will be essential to protect an issuer in these situations.

This article discusses the crowdfunding exemption and the elimination of the general solicitation prohibition on certain private placements. Though these provisions in the JOBS Act may make it easier for a business owner to raise capital, the potentially higher risk of liability after the funds have been raised means entrepreneurs should use these tools carefully.

Crowdfunding.

For start-ups, the most exciting provision of the JOBS Act is the new crowdfunding exemption (most of the excitement is because of the cool name). The purpose of the crowdfunding exemption is to enable a start-up or small business owner to raise capital from a large number of people in relatively small amounts. Plaintiff's lawyers call this group of people a "class."

As noted above, the specific regulations around crowdfunding are yet to be adopted, but the primary rules are as follows:

1. An issuer can only sell up to $1 million in securities in a rolling 12-month period (under this exemption or otherwise);
2. The total amount sold to any investor by an issuer in a rolling 12-month period (under this exemption or otherwise) cannot exceed the greater of $2,000 or 5 percent of the annual income or net worth of the investor (if the income or net worth of the investor is under $100,000) or 10 percent of the annual income or net worth of the investor, with a maximum of $100,000, if the annual income or net worth of the investor is $100,000 or more;
3. The transaction must be conducted through a broker or "funding portal" (I use the term "crowdfunding intermediary" throughout this article for such persons); and
4. The issuer must meet certain disclosure and other requirements.

Before you harass me about the ambiguities and conflicts in the above summary, please note that the statute is written with the ambiguities and conflicts baked right in. It is not clear, for example, what the applicable investment threshold is for an investor if his/her income and net worth straddles the $100,000 mark. The provisions with respect to crowdfunding intermediaries do make clear that the per-investor limits are 12-month limits for all issuers combined (i.e., a person making $20,000 annually can only invest $2,000 total with all issuers in a 12-month period). I will let the SEC figure out how to police that.

As noted above, the transaction must be conducted through a broker or funding portal (a creation under the JOBS Act that is the rough equivalent of a very passive broker) who must be registered with the SEC and an applicable self-regulatory organization. The crowdfunding intermediary must ensure that the investors in the offering (i) obtain the information they need about the issuer (as determined by the SEC in its rules), (ii) understand the risks of buying securities from the issuer and (iii) have not exceeded the per-investor limit on purchasing securities.

The crowdfunding intermediary must perform background checks on directors, officers and certain owners of the issuer, must comply with information security requirements and cannot pay for personally identifiable information of potential investors.

The issuer is required to file with the SEC and provide to investors through the crowdfunding intermediary specific information about the issuer, in-

cluding (1) director, officer, owner and capital structure information, (2) a description of the business plan, (3) a description of the issuer's financial condition (there are differing levels of disclosure depending on the amount of crowdfunding the issuer has undertaken), (4) a description of the use of the proceeds, (5) the price of the securities, target offering amount and deadline to reach the target, and (6) certain risks relating to minority ownership in the issuer and future corporate actions.

The issuer may not advertise a crowdfunding offering except to direct investors to the crowdfunding intermediary, cannot compensate persons for promoting the offering without certain disclosures and must provide the SEC and investors with annual financial and operational statements.

Based on the extensiveness of the statute and the presumed extensiveness of the to-be-issued regulations, the relative costs of raising funds in crowdfunding will be high, at least until a proper market for crowdfunding intermediaries exists. This is without taking into account the fact that the issuer very much should still engage legal counsel to conduct the offering.

The presence of the crowdfunding intermediary and the delineation of disclosure requirements do not eliminate an issuer's liability for material misstatements or omissions in the offering process, though I think many issuers will believe this to be the case. To the contrary, the JOBS Act adds a provision permitting investors to bring a direct action against an issuer for misstatements or omissions made in the offering process, and the principals of the issuer may be held liable for the same.

For this reason, an issuer should treat the required disclosures as the minimum amount of information required in the crowdfunding disclosure documents. Issuers should continue to delineate risk factors and provide issuer information similar to a private placement memorandum utilized for accredited investors, including the information specifically required for crowdfunding.

Elimination of General Solicitation Prohibition.

A frequently used method of raising capital is the Rule 506 offering under Regulation D. Under Rule 506, an issuer may sell an unlimited amount of securities to an unlimited number of "accredited investors" and up to 35 additional purchasers who are by themselves, or with a purchaser representative, sophisticated. "Accredited investors" include certain types of entities, the directors and executive officers of the issuer, and natural persons with either a net worth (jointly with their spouse and excluding their house equity and debt) greater than $1,000,000 or with income in each of the last 2 years of $200,000 ($300,000 jointly with their spouse) and who have a reasonable expectation of reaching the same income level in the current year. If only sales to accredited investors are made, there aren't any specific information requirements that must be provided to investors and only a notice filing must be made at the federal and state levels.

The primary restriction on Regulation D, including Rule 506 offerings, is the prohibition on general solicitation. Issuers are not permitted to offer or sell securities in a Regulation D offering through advertisements or other communications published or broadcast in the media or seminars or meetings where the attendees are invited by a general solicitation or advertisement. The prohibition on general solicitation has long been a burden on potential issuers of securities that arguably deterred them from offering securities. With the Internet and social media, the likelihood of an issuer stubbing his/her toe has certainly increased.

When proposed Rule 506(c), as promulgated under the JOBS Act, takes effect, entrepreneurs will be able to use advertisements and other forms of general solicitation to offer securities, but only so long as all purchasers in the private placement are accredited investors. Theoretically, when proposed Rule 506(c) becomes effective, we may all begin to see mass e-mails, advertisements in the Des Moines Register and online marketplaces offering securities to the general public.

As with crowdfunding, the introduction of Rule 506(c) doesn't mean a start-up or business owner should immediately go into the market and start raising capital as if there are no consequences. The issuer must still contend with the anti-fraud laws (material omissions and misstatements), so issuers should still provide private placement memoranda or other offering documents consistent with the securities laws (though those documents probably no longer need to remain confidential if relying on Rule 506(c)).

Rule 506(c) may be of limited use to a start-up company because the use of advertisements or other methods of general solicitation will preclude the company from selling to friends or family members who are not accredited investors. However, for larger issuers, a fortunate consequence of permitting general solicitation in certain private placements is the alleviation of integration concerns in concurrent or near-in-time private and public offerings.

There are also apparently higher standards for determining whether a person is an accredited investor in a Rule 506(c) offering. Issuers must use "reasonable steps" to determine if a person is an accredited investor. The SEC has indicated a mere questionnaire, which is common practice at this time, will no longer be sufficient. Instead, third party services (perhaps you will want to start one of those) might be used to perform the due diligence necessary to determine if an individual has the appropriate net worth or annual income.

Excitement for crowdfunding and Rule 506(c) is understandable. It is possible that crowdfunding and Rule 506(c) offerings will be very useful tools to business owners; but issuers should be aware of the risks inherent in any securities offering. The new exemptions change the manner of the offering, but the potential liability is still there and likely has increased.

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