

THE JOBS ACT AND ITS IMPLICATIONS ON CAPITAL RAISING FOR STARTUP COMPANIES

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On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the “**JOBS Act**”).¹ The primary intent of the JOBS Act is to drive job creation by facilitating capital raising by startup and emerging growth companies² through the introduction of certain changes to federal securities laws designed to ease restrictions placed on private placement offerings and securities registration requirements.³ The most highly anticipated change caused by the JOBS Act is the enablement of “crowdfunding,” or the ability to sell securities in small amounts to a large number of investors. The changes brought by the JOBS Act likely will have a significant impact on the manner and means through which startup companies will raise capital.

Crowdfunding

Crowdfunding is a financing concept that enables individuals and organizations to pool together capital in order to fund efforts initiated by other people or organizations.⁴ Prior to the JOBS Act, crowdfunding was permitted only for limited endeavors, such as certain charitable purposes and artistic works. For example, Kickstarter operates an online portal through which emerging artists and developers can raise funds from the public for creative projects.⁵ Prior to the introduction of the JOBS Act, the concept of crowdfunding through sales of a startup company’s securities was limited by two significant legal obstacles: first, the sale of securities triggered expensive registration requirements with the Securities Exchange Commission (the “**SEC**”); and second, third-party facilitators of securities sales through crowdfunding were subject to broker-dealer regulations.⁶ As a result of these legal obstacles, pre-JOBS Act crowdfunding platforms developed business

¹ Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

² Throughout this note, the terms “startup(s),” “startup company(s)” and “emerging growth company(s)” are used interchangeably. The JOBS Act defines an “emerging growth company” as an issuer with total annual gross revenues of less than \$1 billion during its most recently completed fiscal year. The phrase total annual gross revenues means total revenues as presented on the income statement presentation under U.S. GAAP.

³ The JOBS Act was specifically created “[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”

⁴ Wikipedia, *Crowdfunding*, http://en.wikipedia.org/wiki/Crowd_funding (Oct. 7, 2012).

⁵ See www.kickstarter.com.

⁶ See generally § 4(6), Securities Act of 1933 § 77d.

models designed (with limited success) to avoid the characterization of crowdfunding as the sale of securities.

Title III of the JOBS Act, more specifically titled “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” or the “CROWDFUND Act,” eases the aforementioned legal obstacles primarily by creating an exemption to the notice filing and registration requirements set forth in the Securities Act of 1933, as amended to date (the “**Securities Act**”) which permits startup companies to raise capital through qualified crowdfunding transactions.⁷ Embedded as the new § 4(6) of the Securities Act, this exemption permits an issuer (i.e., a startup company) to raise up to \$1 million over a 12-month period from a large number of investors that may not meet the SEC’s definition of an accredited investor.⁸

The gross aggregate amount an issuer may sell to an individual investor in any 12-month period is limited to the maximum of: (i) the greater of \$2,000 or 5% of the annual income or net worth of such investor, if either such investor’s net worth or annual income is less than \$100,000; or (ii) 10%, not to exceed \$100,000, of annual income or net worth of such investor, if either such investor’s annual income or net worth is equal to or greater than \$100,000.⁹ Additionally, an investor holding securities sold pursuant to the crowdfunding provisions are not transferable by the investor for 1-year from the date of purchase, unless the securities are transferred to the issuer, an accredited investor,¹⁰ in a registered public offering, or to family of the purchaser, in addition to other transfer restrictions to be imposed during SEC rulemaking.¹¹ The net effect of the JOBS Act reduces the issuer’s regulatory burden normally associated with public fundraising transactions and offerings.¹²

Crowdfunding Portals

⁷ § 301, JOBS Act.

⁸ § 302(a)(6)(A), JOBS Act. Amendments to § 4(6), Securities Act of 1933 § 77d. In pertinent part, the definition of “accredited investor” means any natural person: (i) who has individual net worth, or joint net worth with such natural person’s spouse, that exceeds \$2 million at the time of the purchase of securities, or has assets under management of \$1 million or above, excluding the value of such natural person’s primary residence; or (ii) with income exceeding \$200,000 in each of the two most recent years or joint income with such natural person’s spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. See Rule 501(a) of Regulation D, 17 CFR 230.501(a) (2012).

⁹ § 302(a)(6)(B), JOBS Act. Amendments to § 4(6), Securities Act of 1933 § 77d.

¹⁰ *Supra*, note 8.

¹¹ *Id.*

¹² *Id.*

A crowdfunding offering involving the sale of securities must be conducted through a broker or “funding portal” that meets the qualifications to be established under new SEC rules.¹³ A funding portal must first register an issuer’s crowdfunding offering with the SEC, and make available to prospective investors information regarding the offering at least 21 days before the first day on which the securities are sold.¹⁴ Also, the funding portal must make certain disclosures to investors such as investment risks associated with the offering and other investor education materials, and must implement certain measures to reduce the risk of fraud, such as background and regulatory checks on an issuer’s directors, officers and significant equity holders.¹⁵ Lastly, the funding portal must ensure that no investor exceeds the applicable investment limits in the aggregate for all investments made by the investor in any 12-month period.¹⁶

Also, it is important to note that funding portals are subject to strict regulations with respect to its permitted activities. A funding portal intermediary is not permitted to: (i) offer investment advice or recommendations; (ii) solicit purchases, sales or offers to buy the securities listed on such funding portal’s website or compensate persons for such solicitations; (iii) compensate employees, agents or other persons for such solicitations or based on the sale of securities displayed or referenced on its website or portal; (iv) hold, manage, possess, or otherwise handle investor funds or securities; or (v) engage in certain other restricted activities as determined by the SEC.¹⁷ While noting that a funding portal will be subject to SEC rules and registration, the JOBS Act specifically exempts a funding portal from registering as a broker-dealer.¹⁸

Issuer Regulations

Issuers engaged in crowdfunding must meet a number of disclosure and filing requirements both to the SEC and investors. An issuer’s disclosure obligations

¹³ § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a. Issuers are subject to stringent issuer regulations, including, without limitation, the provisioning of financial information and other offering related information.

¹⁴ *Id.*

¹⁵ Per § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a. Major equity holders are individuals or entities who own more than 20% of the shares of the issuer.

¹⁶ § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a. Crowdfunding portals are required to ensure that investments facilitated through such intermediary are compliant with investor regulations.

¹⁷ § 304, JOBS Act. Amendment to Securities Exchange Act of 1934 § 78c.

¹⁸ § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a. A funding portal is required to either register as a broker-dealer, or as a funding portal.

vary based on the size of the proposed offering.¹⁹ Issuers raising less than \$100,000 in a crowdfunding offering are required to produce income tax returns for the most recently completed year and financial statements certified by the issuer's principal executive officer as true and complete in all material respects.²⁰ Issuers raising between \$100,000 and \$500,000 in a crowdfunding offering are required to provide financial statements reviewed by an independent public accountant.²¹ Issuers raising in excess of \$500,000 in a crowdfunding offering must provide audited financial statements.²² In addition to these financial statements, issuers also are required to file with the SEC and make available to investors and the funding portal certain basic information about such issuer; and to make annual filings with the SEC regarding such issuer's results of operations and financial condition.²³ Basic information includes basic corporate information, names of officers and directors, major equity holders, description of the business, a stated purpose and use of the offering's proceeds, the target offering amount and deadline, as well as the price of the securities, and certain other information as required by the SEC.²⁴

Additional Capital Raising Initiatives under the JOBS Act

The JOBS Act also amends the Securities Act to provide additional capital raising opportunities for startup companies. Specifically, a key element of the JOBS Acts eliminates the prohibition on general solicitations and general advertising in connection with a private offering.²⁵

Most securities offerings by startup companies are conducted under Rule 506 of the Securities Act. The current ban on general solicitations and general advertising have limited startup companies to raising capital from existing investors, or from potential investors with which they or their contacts have preexisting relationships.²⁶ The JOBS Act eliminates the prohibitions on general solicitation and general advertising in connection with a private offering conducted under Rule 506, provided that all investors acquiring securities in the offering are

¹⁹ § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a.

²⁰ § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a. Setting forth the tiered disclosure regime.

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ § 302(b), JOBS Act. Amendment to § 4(6), Securities Act of 1933 § 77a. Setting forth the SEC disclosure requirements of an issuer.

²⁵ Under Title II of the JOBS Act, Access to Capital for Job Creators, § 201 JOBS Act, the general ban on advertising and solicitation is lifted specifically for capital raising efforts to accredited investors.

²⁶ Regulation D, Rule 506, 17 C.F.R. § 230.506.

accredited investors.²⁷ An issuer seeking to make a general solicitation will be required to take reasonable steps to verify that each investor in the offering is accredited, using methods to be determined by the SEC.²⁸

Impact of Crowdfunding and the JOBS Act on Startup Companies

The enactment of the JOBS Act is intended to assist entrepreneurs and startups to obtain capital and financing outside of traditional and conventional sources of funding. As indicated in this note, the JOBS Act's enablement of crowdfunding expands the financing options available to startup companies. Despite the enablement of crowdfunding as a capital raising mechanism, startup companies should not engage in crowdfunding or any other activity enabled under the JOBS Act until the SEC finalizes its rulemaking regarding the specific provisions of the JOBS Act.²⁹ When the SEC rulemaking is finalized, startup companies should engage attorneys to ensure their crowdfunding offering does not violate applicable laws. Apart from regulatory compliance, a crowdfunding offering raises a number of other related legal issues for consideration. Examples of such legal issues include:

- **Corporate Clean Up.** Prior to engaging in a crowdfunding offering, a startup company should ensure its corporate house is in order. For example, a startup company must verify that it has authorized the appropriate number and type of shares to be sold in connection with its crowdfunding offering.
- **Securities Filings.** A startup company must ensure that it makes or will make in a timely manner all SEC filings required under the JOBS Act. Although these filing requirements will be less burdensome compared with filing requirements in connection with traditional public offerings, missteps in filings may result in director or officer liability.³⁰
- **Shareholders' Agreements.** As a startup company will gain new shareholders as a result of the crowdfunding offering with which such

²⁷ § 201, JOBS Act. Amendment to Regulation D, Rule 506, 17 C.F.R. § 230.506.

²⁸ *Id.*

²⁹ As of the publication date of this note, the SEC has not completed any JOBS Act rulemaking. For further information, the full text of the SEC warning is available on the SEC's website at <http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm>. Conducting a crowdfunding offering to unaccredited investors would violate the Securities Act as it currently exists, and may result in the SEC's determination that an issuer is a "bad actor" under the JOBS Act. Such designation may preclude a startup company from subsequently utilizing crowdfunding to raise capital.

³⁰ Since crowdfunding offerings will be open to a large public audience, the shareholder composition after an offering may result in a large number of shareholders. Accordingly, it may be wise for startups to review its director and officer indemnification provisions under its certificate or articles of incorporation, or bylaws, and consider obtaining director's and officer's liability insurance.

startup company may not have a preexisting relationship, the company should consider whether these new shareholders should be required to enter into agreements with the company which impose restrictions on share transfers. Examples of such restrictions include company rights of refusal and market stand-off provisions.

- **Tax Returns.** An early-stage startup company that has not yet filed a tax return may be precluded from utilizing the Securities Act's crowdfunding exemption. Even if a company has filed a tax return, it may not have complied with all financial reporting requirements by the time it decides to undertake a crowdfunding offering.
- **Public Disclosure.** As discussed in this note, qualifying for the crowdfunding exemption requires the disclosure of certain operational and financial information. Upon disclosure, such information will become publicly available. Prior to complying with the crowdfunding exemption, a startup company should evaluate the potential consequences of making such information publicly available.

Conclusion

The JOBS Act is an important legislative act which ultimately is intended to create jobs by easing access to capital for startup companies. As a result of the JOBS Act, startup companies will be permitted to approach a wider pool of potential investors. Moreover, startup companies will be able to advertise or provide notice of any proposed crowdfunding offering over the Internet, in newspapers or through other marketing channels, so long as the investors are accredited investors. While crowdfunding may only create a narrow exemption to the public sale of securities to unaccredited investors, the removal of advertising and solicitation restrictions under Rule 506 of the Securities Act will have a significant impact on the capital-raising methods used by startup companies. Although these new rules will provide startup companies with access to a wider variety of investment and capital raising channels than previously permitted, it has yet to be determined whether this will result in a change of traditional venture capital offerings. As early-stage investors generally require a fair amount of personal interaction and evaluation over an extended period of time, a crowdfunding exemption may not result in any difference to the venture capital market. Nonetheless, for the reasons discussed in this note, once the SEC rules on crowdfunding are finalized and the market adopts crowdfunding offerings, startup companies should carefully evaluate whether crowdfunding is the best and most viable capital raising mechanism for them in light of their current circumstances and various legal considerations, including the considerations set forth in this note.