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JOBS Act takes look at 'crowdfunding'

As everyone who reads, listens or looks around knows by now, President Barack Obama signed the bipartisan-supported Jumpstart Our Business Startups Act on April 5. The JOBS Act covers many legislative initiatives. It creates an "emerging growth company" concept to ease entry to the IPO marketplace; expands availability of Regulation A public offerings; raises Section 12(g) triggers for the Securities Exchange Act of 1934 reporting; and removes the general solicitation limitation from Rule 506.

Among these is Title 3, or the "crowdfunding" exemption from the registration requirements of the Securities Act of 1933, which directs the SEC to create a new Section 4(6) exemption from registration by Dec. 31. The stated objective of the JOBS Act and, in particular Title 3, is to expand capital-raising opportunities for smaller companies without compromising investor protections, which are the hallmarks of the 1933 and 1934 acts.

Title 3 authorizes the creation of exemptions from offering registration the sale of securities to raise up to \$1 million in a 12-month period, provided the investors do not invest about 10 percent on the high side (with a \$100,000 maximum) or 5 percent on the low side (with a \$2,000 minimum), of their annual income/net worth or, as I refer to it as, the "wealth test." Thus, if the full \$1 million is to be raised, then there will be a minimum of 10 new investor-owners, on the low end, and upwards of 500 on the high end. At the outset, this investor qualification factor will be a verification challenge and

data privacy concern. However, the greater challenge may be ongoing administrative issues presented by holding investor-owner meetings, establishing quorums, preparing annual investor-owner reports, achieving applicable voting consensus for company sales, mergers and other organic corporate events, not to mention imposing transfer restrictions on such securities.

As I am sure many attorneys can recount numerous bitter business breakup stories with as little as two owners (who shrugged off the buy-sell agreement as a legal nicety), our role in educating business clients on the niceties of corporate law will now be exponentially greater.

While we will not know exactly how "crowdfunding" will work or the ultimate regulatory compliance that will be involved in executing such an offering until the rules come out, we do know the following to be true:

- The JOBS Act does not eliminate anti-fraud rules and all issuers and intermediaries must control communications for

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material misstatements and omissions;

- The "crowdfunded" offering will be subject to integration with other exempt offerings for compliance purposes;
 - The issuers and the funding portals will be subject to SEC and Financial Industry Regulatory Authority (FINRA) regulation and oversight and the "bad actor" provisions of securities regulation;
 - Annual reporting to the SEC and the investor-owners will be required, including, eventually audited financial statements;
 - There will still be compensatory restrictions on promoters, finders and other lead generators; and
 - The new investor-owners will have all the rights and remedies provided to stakeholders under the applicable business entity statutes and case law.
- In the "Entrepreneurs Unplugged" section of Crain's Chicago Business, Stella Fayman wrote on March 26, about the "startup 'crowdfunding' bill" noting the entrepreneurial community should take advantage of this fund raising method.

These words echo Obama's comments when he signed the JOBS Act, that "because of this

bill, startups and small business will now have access to a big, new pool of potential investors — namely the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."

However, this new pool will certainly bring corporate housekeeping to the forefront as Yochiro Taku noted in his May Business Law Today article, "Crowdfunding: Its Practical Effect May Be Unclear Until SEC Rulemaking is Complete," noting, among the other realities of wide-scale capital-raising, that:

- The "bad actor" provisions mean no issuer can begin "crowdfunding" until the rules are promulgated;
- "Crowdfunding" will expand small companies' financing options;
- Issuers will still need effective attorneys to ensure their corporate house is ready and able to work with new stockholders;
- The potential for officers and directors bearing liability for securities compliance before, during and after an offering will require administrative resources typically not present in small business organizations;
- Ultimately, the SEC rules for "crowdfunding" offering materials may result in the need to draft prospectus-like documents;
- "The increase in number of stockholders as a result of "crowdfunding" may result in increased administrative burdens on issuers."

Based on the buzz about "crowdfunding," it is easy for clients to see it as a panacea, but it is clearly not going to be a painless. Also, it bears repeating, "crowdfunding" is not legal yet.