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The JOBS Act: Easing Exempt Offering Restrictions

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The JOBS Act significantly eases some of the restrictions on exempt offerings under the Securities Act of 1933 (Securities Act) and updates thresholds that would trigger reporting under the Securities Exchange Act of 1934 (Exchange Act). In particular, the JOBS Act:

- directs the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D, provided that the securities are sold only to accredited investors, and under Rule 144A offerings, provided that the securities are sold only to persons who the seller (and any person acting on behalf of the seller) reasonably believes is a qualified institutional buyer (QIB);
- establishes a new offering exemption under Securities Act Section 3(b), which will permit companies to offer and sell up to \$50 million in securities in a public offering within a 12-month period; and
- increases the number of holders of record of equity securities that private companies are permitted to have before requiring registration and reporting under the Exchange Act.

Private Offering Reforms

Title II of the JOBS Act directs the SEC to permit general solicitation and gen-

eral advertising for offerings conducted under Rule 506 of Regulation D and Rule 144A of the Securities Act, provided that Rule 506 sales are made only to investors who are "accredited" and Rule 144A resales are made only to investors who are "qualified institutional buyers," as each of those terms is defined under the federal securities laws. Title II also provides that general solicitation and general advertising will not cause a Rule 506 offering to be deemed a "public offering."

Rule 506 Offerings: The Current Regime

Rule 506 is the most popular means for conducting a private offering, because it permits issuers to raise an unlimited amount of money and pre-empts state securities laws. Generating interest in a Rule 506 offering is sometimes difficult for companies, due in part to a long-standing prohibition against general solicitation and general advertising. This prohibition has meant that issuers can offer securities only to investors with whom there is a pre-existing relationship, and that they cannot advertise the offering in order to reach a broad group of potential investors. Some companies undertaking private capital-raising activities are able to access a larger group of potential investors by engaging a registered broker-dealer who has preexisting relationships with such persons. This alternative may not be available, however, if the company is too early in its develop-

ment to interest a broker-dealer to expend the effort to undertake an offering.

Rule 144A Offerings: The Current Regime

Rule 144A, which is a popular means for conducting large private offerings, permits financial intermediaries to buy securities from an issuer and resell them to an unlimited number of QIBs in transactions that comply with the conditions of Rule 144A. Those QIBs can in turn trade the securities among themselves in transactions that comply with the conditions of Rule 144A. Rule 144A(d)(1) provides that the securities must be offered and sold only to a QIB or an offeree or purchaser that the seller (and any person acting on behalf of the seller) reasonably believes to be a QIB. As a result, Rule 144A currently prohibits offers to non-QIBs, thus preventing the use of any general solicitation or general advertising in connection with a Rule 144A offering.

Private Offerings after the JOBS Act

The amendments to Rules 506 and 144A contemplated by the JOBS Act remain subject to SEC rulemaking, which the JOBS Act directs the SEC to complete by July 4, 2012. The revised rules will permit broader communications by issuers and Rule 144A sellers, allowing notice of accredited- and QIB-only offerings in any manner, including through unrestricted issuer or intermediary websites and social

media sites, as well as print, radio, and television advertising. Until the rules are amended, however, market participants should continue to comply with the existing rules and follow customary procedures with respect to these offerings.

The JOBS Act directs the SEC to revise Rule 506 to provide that the prohibition against general solicitation or general advertising in Rule 502(c) shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors. Under the SEC's existing definition, an accredited investor is a person who falls within one of the categories specified in the definition, or a person whom the issuer reasonably believes falls within one of those categories. The revised rules must further require that issuers utilizing general solicitation or general advertising in connection with Rule 506 offerings take reasonable steps to verify that purchasers of securities are accredited investors, using methods to be determined by the SEC. With respect to Rule 144A, the rule as revised must provide that securities may be offered to persons other than QIBs, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a QIB.

The JOBS Act also provides certain intermediaries with greater latitude to assist with Rule 506 offerings, without requiring registration of those intermediaries as broker-dealers. Specifically, such third-parties will not be required to register as broker-dealers solely because they operate websites or other platforms that facilitate the offer, sale, purchase, or negotiation of or with respect to securities, or that permit general solicitation or general advertising in connection with Rule 506 offerings, or that provide ancillary services such as due diligence or standardized documentation, provided that such third-parties: (1) receive no compensation in connection with the purchase or sale of the securities; (2) do not hold investor funds or securities in connection with the transaction; and (3) are not subject to statutory "bad actor"

disqualification provisions.

Once the SEC's rules are in place, a practice of broadly disseminated announcements of Rule 506 and Rule 144A offerings is likely to develop. It may become more common for issuers to use third-party matching and marketing platforms in order to facilitate these offerings. Until the new rules are effective, issuers and intermediaries must continue to comply with current regulations.

The Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association has submitted a pre-rulemaking comment letter regarding the elimination of general solicitation and general advertising restrictions in connection with Rule 506 and Rule 144A transactions, which is available [here](#). Other pre-rulemaking comment letters relating to Title II of the JOBS Act are available [here](#).

No Fraud Allowed

Although the JOBS Act relaxes restrictions on the audience for communications, it does not eliminate anti-fraud rules. Issuers and intermediaries must continue to ensure that communications do not contain material misstatements or omissions that could subject them to liability in connection with the offering.

A New Small Public Offering Exemption

In addition to easing restrictions on private capital-raising efforts as discussed above, the JOBS Act establishes a new exemption pursuant to new subparagraph (2) of Section 3(b) of the Securities Act. The JOBS Act gives the SEC significant latitude in crafting this new exemption, and in many ways it appears to be similar to current Regulation A, which permits private companies to conduct small public offerings without registration. Some commentators have referred to this new exemption as "Regulation A+."

Regulation A Offerings: The Current Regime

Today, Regulation A provides some advantages over a private offering, because

it permits limited solicitations of interest (sometimes referred to as "testing the waters") and purchasers receive securities that are not "restricted securities" under federal securities law. In addition, Regulation A calls for less extensive disclosure than a traditional initial public offering and, although a very successful public offering under Regulation A could result in the company having a number of holders of record that would require registration under Section 12(g) of the Exchange Act following the end of the fiscal year, Regulation A does not in and of itself trigger ongoing periodic reporting obligations under the Exchange Act. Regulation A has, however, fallen out of favor because of the \$5,000,000 limit on aggregate consideration to be received for securities offered thereunder, including no more than \$1,500,000 of securities offered by selling shareholders, in any 12-month period. In addition, companies relying on Regulation A must comply with state regulations in every state where the offering occurs.

The New Small Offering Exemption

Title IV of the JOBS Act directs the SEC to establish an exemption for offerings of up to \$50,000,000, without a maximum for selling shareholders, in any 12-month period. In order to maintain the utility of the new exemption, the JOBS Act requires the SEC to consider adjustments to the dollar limitation every two years. Companies will be permitted to offer equity securities, debt securities, and debt securities convertible or exchangeable into equity interests, including any guarantees of such securities.

Although the new exemption would not trigger required periodic reporting under the Exchange Act pursuant to Securities Act Section 15(d), it will, among other things, subject a company to the civil liability provisions of Section 12(a)(2) of the Securities Act and require the filing with the SEC of annual audited financial statements. Through rulemaking, the SEC may also require that the company file with the SEC and distribute to potential investors an offering statement, and may require the company to file additional periodic disclosures.

Like existing Regulation A, the new exemption will allow for solicitations of interest (“testing the waters”) and purchasers in such offerings will receive securities that are not “restricted securities.” In addition, securities offered under this exemption will be considered “covered securities” under the National Securities Market Improvements Act of 1996 (NSMIA), and therefore not subject to state securities registration and qualification requirements, but only if the securities are offered or sold on a national securities exchange (which would require Exchange Act registration under Section 12(b) of the Exchange Act), or offered or sold to a “qualified purchaser,” which is a term yet to be defined by the SEC.

Stay Tuned for Rulemaking

There is no timeframe within which the SEC is required to adopt regulations implementing so-called “Regulation A+.” The most controversial aspect of Title IV is likely to be the scope of the state law pre-emption. The JOBS Act directs the U.S. Comptroller General to complete a study by early July 2012 (three months after enactment) regarding the impact of state laws regulating securities offerings on Regulation A offerings.

Increases in Exchange Act Registration Triggers

While the amendments described above will be useful for capital-raising by private companies, their benefits would be muted in the absence of an increase to the mandatory Exchange Act registration triggers that permits companies to stay private longer. Accordingly, the JOBS Act increases the number of holders of record of a company’s equity securities that are permitted before the company must register under the Exchange Act and begin public reporting.

Section 12(g): Before the JOBS Act

Before the JOBS Act, a company was required to register under Section 12(g) of the Exchange Act and begin the periodic reporting process if, at the end of its fiscal year, the company had at least \$10 million

in assets and a class of equity securities held of record by 500 or more persons. Under this provision, financing rounds and equity compensation arrangements led many private companies either to become subject to public disclosure rules long before they were ready to go public, or to engage in share buy-backs or other means to avoid or delay registration.

Relief from Exchange Act Registration

The JOBS Act raises the Section 12(g) registration thresholds and thereby improves the utility of the JOBS Act capital formation provisions. As amended, Section 12(g) will now require registration if, at the end of its fiscal year, a company has at least \$10 million in assets and a class of equity securities held of record by either (1) 2,000 persons, or (2) 500 persons who are not accredited investors. Banks and bank holding companies are not required to register unless they have, at the end of the fiscal year, at least \$10 million in assets and a class of equity securities held of record by 2,000 or more persons.

Importantly, the definition of “holders of record” will also be amended to exclude securities held by persons who received the securities in exempt transactions under an employee compensation plan, or pursuant to the JOBS Act crowdfunding exemption (see “[Crowdfunding: Its Practical Effect May Be Unclear Until SEC Rulemaking is Complete](#)”). Since these are two of the most likely avenues for the issuance of securities to non-accredited investors, a company could potentially have a significant number of non-accredited investors that will not be counted against the 500 holder-of-record limit (or the 2,000 holder-of-record limit for banks and bank holding companies) described above. It remains to be seen how difficult it will be for nonpublic companies to monitor the accredited investor status of their shareholders. Except for banks and bank holding companies, the deregistration thresholds under Sections 12(g) and 15(d) of the Securities Act have not been amended.

The SEC has posted an [initial series of “frequently asked questions”](#) regarding

implementation of the amendments to Section 12(g).

Conclusion

The JOBS Act aims to afford significantly more latitude for capital-raising efforts, particularly for private companies. As the SEC develops its rules under the JOBS Act, it will have to balance the need to promote capital formation with the goal of protecting investors. Ultimately, we can expect to see a much more “public” private offering market, and perhaps new alternatives to the traditional initial public offering.

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