JOBS Act to Relax Rules on Securities Offerings

The Jumpstart Our Business Startups Act was approved by the U.S. Senate on March 22, 2012. It is expected that the U.S. House of Representatives will approve the Senate-approved version of the Act and that President Obama will sign the Act into law within the next few days. The Act is intended to facilitate capital formation in a variety of ways – including by making the IPO process less burdensome for “emerging growth companies,” a new class of issuer including currently private companies with annual revenues of less than $1 billion. Some of the Act’s provisions will become effective immediately upon enactment, while others will require rulemaking, in some cases under tight deadlines, by the Securities and Exchange Commission. Below is a summary of provisions of the Act we believe have the greatest potential impact on the financial markets and market participants, assuming the Senate-approved version of the Act becomes law.

It remains to be seen whether in practice the Act will have the intended results, and whether the investor protection concerns raised by some critics of the Act will prove well founded.

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I. Emerging Growth Companies

Immediately upon enactment, the Act will create a new category of issuer, emerging growth companies (“EGCs”), and will allow EGCs to take advantage of significant regulatory concessions in carrying out an equity IPO and for up to five years after an IPO (the so-called “IPO on-ramp” provisions).

Definition

The Act defines an EGC as an issuer with total annual gross revenues of less than $1 billion during its most recent financial year. An issuer that was an EGC as of the first day of that financial year will remain an EGC until (i) the last day of the financial year five years after its initial public offering, (ii) the last day of the financial year in which it has annual gross revenues of $1 billion or more, (iii) it has issued more than $1 billion in non-convertible debt during a three-year period, or (iv) it is a "large accelerated filer" (generally, a company with a public float of at least $700 million that has been publicly reporting for at least one year). For an issuer to qualify as an EGC, its initial registered public offering of common stock must not have occurred on or before December 8, 2011. By its terms, the Act generally applies equally to domestic and foreign EGCs.

Scaled Disclosure and Other Exemptions

The Act permits an EGC to include only two years of audited financial statements in its IPO registration statement, rather than the three years otherwise required. Similarly, the Act permits an EGC to cover only two years of financial information in the MD&A section of its IPO registration statement. As for the presentation of "selected financial data," which ordinarily covers five years, the Act permits an EGC to omit selected financial data for any period prior to the earliest audited period presented in its initial registration statement.

The Act's provisions modifying the selected financial data and MD&A disclosure requirements do not apply directly to a foreign private issuer using Form 20-F or the Securities Act forms that refer to Form 20-F for their content. The provisions refer specifically to sections of Regulation S-K that apply to domestic issuers but not to the corresponding items of Form 20-F. It remains to be seen whether the SEC will make corresponding changes to the Form 20-F requirements so that foreign issuers employing the foreign issuer forms can make full use of the scaled disclosure dispensation granted EGCs.

The Act limits the executive compensation disclosures required under Item 402 of Regulation S-K in Exchange Act reports of domestic issuers to the disclosures required of smaller reporting companies. Consequently, among other things, an EGC may (i) omit the Compensation Disclosure and Analysis, (ii) provide the summary compensation table for two years rather than three, and (iii) provide compensation information for three named executive officers (including the CEO) rather than five.

The Act also exempts EGCs from certain corporate governance requirements that were established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). EGCs will be exempt from the requirement that public companies hold non-binding stockholder votes on executive compensation arrangements (the so-called "say-on-pay" and "say-on-golden parachute" provisions). Smaller reporting companies are currently exempt from such requirements until 2013. EGCs also will be exempt from the requirements that public companies disclose (i) "pay-versus-performance" information showing the relationship between executive compensation paid and the financial performance of the issuer and (ii) the median total compensation of all employees compared to the CEO.

Research Analysts and Reports

Research Analyst Involvement in IPOs

For EGCs, the Act will remove certain measures put in place pursuant to the Sarbanes-Oxley Act of 2002 ("SOX") to enforce a separation between research analysts and investment bankers who work in the same firm. In connection with an EGC's IPO, the Act will prohibit the SEC and registered national securities associations (currently only the Financial Industry Regulatory Authority ("FINRA")) from (i) restricting which associated persons of a broker-dealer may arrange for communications between analysts and potential investors and (ii) restricting analysts from participating in communications with an EGC's management team that are also attended by an associated person of a broker-dealer whose functional role is not that of a securities analyst.

FINRA and the New York Stock Exchange ("NYSE") both adopted rules pursuant to SOX on research conflicts of interests (FINRA Rule 2711 and NYSE Rule 472). While the Act will prohibit the SEC and FINRA from adopting or maintaining rules to restrict the EGC IPO-related activities described above, the Act will not prohibit national securities exchanges (such as the NYSE) from adopting or maintaining such rules. However, the exclusion of the NYSE from the scope of the Act's prohibitions should have no practical effect. In 2007, the SEC approved an agreement to reduce regulatory duplication for members of both FINRA's predecessor and the NYSE by allocating to FINRA sole regulatory responsibility for specified NYSE rules, including NYSE Rule 472. As a result, the NYSE no longer has any examination, enforcement or surveillance responsibilities for that rule.

The Act does not, however, address the restrictions of the court-ordered undertakings in the Global Research Analyst Settlement that were entered into in 2003 among 12 investment banks and the SEC. For example, pursuant to the undertakings, subject investment banks must continue to comply with restrictions that limit research analysts and investment bankers from participating in joint communications with a management team unless the purpose is for due diligence and the joint communications are chaperoned by internal legal or compliance staff or outside counsel. The Act will allow joint communications with an EGC management team for any purpose, without a chaperone. To take advantage of the loosening of restrictions provided by the Act, investment banks subject to the Settlement undertakings presumably would need to request the court's relief from those restrictions, which would require that the SEC join in the request.

Restrictions on the interaction of research analysts and investment bankers, other than those restrictions specifically lifted by the Act, remain in effect. For example, under FINRA Rule 2711, oral or written communications between research analysts and investment bankers concerning the content of a research report are limited to verifying factual accuracy and must be made through legal or compliance personnel.

Blackout Periods

The Act will also prohibit the SEC and FINRA from restricting brokers, dealers or FINRA members from publishing or distributing any research reports or making a public appearance concerning an EGC's securities within a specified time period after the EGC's IPO or prior to the expiration of an EGC's IPO lock-up period.

Currently, restrictions arise under the "blackout provisions" of FINRA Rule 2711, which prohibit any FINRA member acting as an underwriter in an IPO from (i) publishing or distributing any research report for 40 days following the date of the offering, if acting as a manager or co-manager, (ii) publishing or distributing any research report or making any public appearance for 25 days following the date of the offering, if participating other than as a manager or co-manager, and (iii) publishing or distributing any research report or making any public appearance for 15 days prior to and after the expiration, waiver or termination of a lock-up agreement, if acting as a manager or co-manager. Certain other "blackout" provisions of FINRA Rule 2711 will remain unaffected by the Act, such as those related to publishing research and making appearances in connection with certain equity offerings by issuers and selling security holders following an IPO.

The unavailability of the "dealer's exemption" in Section 4(3) of the Securities Act for 40 days following a registered IPO (or 25 days for listed companies), which effectively prevents the distribution of research by broker-dealers during that period, should not restrict the distribution of research following initial public offerings of EGC common stock. The Act states that the publication or distribution by a broker or dealer of research reports about an EGC in connection with any public offering of common stock shall not constitute an "offer for sale" or an "offer to sell" a security for purposes of the definition of "prospectus" in Section 2(a)(10) of the Securities Act. Therefore, the distribution of research will not be subject to the prohibition in Section 5(b)(1) of the Securities Act on the distribution of a non-complying prospectus.

As with the Act's prohibitions on certain restrictions involving interaction between analysts and investment bankers, the exclusion of securities exchanges (such as the NYSE) from the scope of the Act's prohibitions relating to blackout periods should have no practical impact. Although the provisions relating to blackout periods in FINRA Rule 2711 are mirrored in NYSE Rule 472, FINRA has sole regulatory responsibility over the NYSE's rule.

Research Reports

The Act provides that pre-deal research reports on an EGC do not violate the "gun jumping" restrictions under the Securities Act. This applies to all public offerings of common stock by EGCs (not just EGC IPOs). The Act provides that the publication or distribution of a research report by a broker or dealer about an EGC that is the subject of a proposed public offering of common stock pursuant to an SEC registration statement will not constitute an offer for sale or offer to sell a security for purposes of Section 2(a)(10) or Section 5(c) of the Securities Act, regardless of whether the registration statement has been filed or is effective, and regardless of whether the broker or dealer will participate in the offering.

This lifting of prohibitions on underwriter research is more expansive than the safe harbor currently provided by Rule 139 under the Securities Act for pre-offering research, which is designed to permit the continuation of ordinary course research on companies that are already traded. The definition of "research report" as used in the Act is broader than the definition of "research report" used in Rule 139, in that it includes oral communications. This difference is rooted in the difference in objectives between the Act (fostering research coverage of EGCs to facilitate their common stock offerings) and Rule 139 (not interfering with on-going research).

By eliminating research reports on EGCs from the definition of "prospectus" in Section 2(a)(10) of the Securities Act, the Act also affects the liability regime of the Securities Act, because research reports on EGCs will no longer be subject to liability for material misstatements or omissions under Section 12(a)(2). Because Section 12(a)(2) refers separately to oral statements, however, materially defective oral communications may still fall within Section 12(a)(2)'s liability provisions, whether or not they are research reports. In addition, research reports will still fall within the definition of "offer" covered by the anti-fraud provisions of Section 17 of the Securities Act and enforceable by the SEC. It also is not clear how, in the context of the application of Rule 159 under the Securities Act to Section 12(a)(2), the contents of research reports, while themselves not offers for purposes of Section 12(a)(2), will be taken into account under Rule 159, which requires evaluation of Section 12(a)(2) liability at the time of sale to an investor against the backdrop of all information (presumably including the contents of research reports) conveyed to investors.

Significantly, the Act also does not limit the potential for federal securities law anti-fraud liability for such reports under Section 10(b) of the Exchange Act. Accordingly, it remains to be seen whether underwriters will accept the liability risk associated with publishing research concerning EGCs that will be permitted by the Act. In another context, which arguably involves less risk of anti-fraud liability because the prospective investors are "qualified institutional buyers" ("QIBs"), many investment banks restrict the distribution of pre-deal research to QIBs in advance of Rule 144A offerings, when there plainly is no risk those research reports would violate Section 5 of the Securities Act.

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Auditor and Accounting Issues

The Act will exempt EGCs from any rules promulgated by the Public Company Accounting Oversight Board (the "PCAOB") that require mandatory audit firm rotation or a supplement to the auditor's report in which the auditor provides additional information about the audit and the financial statements of the EGC. This provision refers to concept releases on these subjects issued by the PCAOB in 2011. The Act further provides that any new rules issued by the PCAOB will not apply to audits of EGCs unless the SEC determines that the application of the additional requirements is necessary or appropriate in the public interest, after weighing investor protection and efficient market considerations.

EGCs will also not be required to comply with new or revised U.S. GAAP accounting standards until companies that are not subject to periodic reporting under the Exchange Act are required to comply, if such standards apply to companies that are not reporting companies. If there is a standard that applies to both reporting and non-reporting companies and there is no separate effective date for non-reporting companies, EGCs will be required to comply with the new or revised standard at the same time as other reporting companies.

EGCs will be exempt from Section 404(b) of SOX, which requires an independent audit of a company's assessment of its internal control over financial reporting as a component of its financial statement audit. An EGC will be required to establish and maintain internal control over financial reporting, as mandated by Section 404(a) of SOX, and its CEO and CFO will have to certify its periodic reports.

"Test the Waters" Provisions

The Act will permit oral and written pre-filing and post-filing communications by an EGC, or a person authorized to act on the EGC's behalf, with QIBs and institutional accredited investors to determine whether such investors have an interest in the contemplated securities offering, without being subject to current "gun jumping" restrictions on pre-filing communications in Section 5(c) of the Securities Act or the requirement that any post-filing written communication conform to a Securities Act Section 10 prospectus or a Rule 433 free writing prospectus.

Notwithstanding the changes introduced by the Act, both issuers and underwriters will be subject to potential federal securities law anti-fraud liability for any oral or written communications that will be permitted by the "test the waters" provisions of the Act.

Confidential Review

Under the Act, an EGC will be permitted to submit a draft IPO registration statement to the SEC confidentially, as long as the initial confidential submission and all amendments are publicly filed not later than 21 days before the company begins its pre-IPO road show for potential investors. The confidential submission begins the SEC review process without publicly revealing sensitive commercial and financial information to competitors. Confidential review has until now been available only to foreign issuers under certain circumstances and to other issuers under extremely limited circumstances.

The requirement that an EGC publicly file its IPO registration statement at least 21 days before the commencement of its pre-IPO road show may lead EGCs either to publicly file their IPO registration statements prior to completion of the SEC's review or to delay their commencement of road shows and other marketing activities for a period after completion of review. The Act provides that an EGC's correspondence with the SEC staff in the comment and response process will not be subject to disclosure under the Freedom of Information Act and will be deemed to constitute confidential information for purposes of Section 24(b)(2) of the Exchange Act, making it unlawful for any member, officer, or employee of the SEC to disclose such information.

Decimalization Study

The Act directs the SEC to conduct a study examining the transition to trading and quoting securities in one penny increments, also known as decimalization. Since the introduction of decimalization in 2001, the question has been raised from time to time whether decimalization, and the resulting potential adverse effect on the profitability of market making, has reduced secondary market liquidity in small cap stocks and thus reduced the number of small cap IPOs. The SEC has not publicly addressed the issue. If the SEC, after completing the decimalization study, determines that the securities of EGCs should be quoted and traded using a minimum increment of greater than one penny, the Act states that the SEC may designate a minimum increment for securities of EGCs that is greater than one penny but less than ten cents by rule not later than 180 days from the date of enactment.

Regulation S-K Study

The Act directs the SEC to conduct a review of Regulation S-K to analyze the current registration requirements of the regulation and to determine how those requirements can be updated to modernize and simplify the registration process and to reduce the costs and other burdens associated with those requirements for EGCs. Within 180 days after enactment, the SEC must provide Congress with a report of its review, which shall include specific recommendations on how to streamline the registration process for EGCs.

II. Public Company Registration Thresholds

Section 12(g) of the Exchange Act, together with related rules, currently requires most U.S. companies to register a class of equity securities with the SEC if those securities are held by 500 or more holders of record and the company has total assets of more than $10 million (other than listed companies, which are separately required to register). After a company registers with the SEC under Section 12(g), it must comply with the applicable Exchange Act reporting requirements.

The Act will change the statutory requirements relating to mandatory registration under the Exchange Act by increasing certain thresholds and by excluding certain categories of holders, including persons who received securities pursuant to employee compensation plans in transactions exempt from Securities Act registration. For issuers other than banks and bank holding companies, the Act will increase the holder of record threshold from 500 persons to 2,000 persons, provided fewer than 500 holders are not accredited investors. For banks and bank holding companies, the Act will set the total asset threshold at $10 million and the holder of record threshold at 2,000 persons, with no limit on the number of investors that are not accredited investors. The Act will also allow banks and bank holding companies to terminate the registration of a class of securities under Section 12(g) if such class is held of record by less than 1,200 persons, an increase from the 300 person threshold currently. These bank-related provisions appear to be intended to accommodate concerns of smaller community banks.

The Act directs the SEC to issue final regulations to implement the provisions of the Act relating to holder of record registration thresholds within one year of enactment. The Act also provides that, with respect to registration requirements, the definition of "held of record" shall not include securities held by persons who received them pursuant to employee compensation plans in transactions exempt from Securities Act registration, as discussed above, or securities held by persons who purchased them in crowdfunding transactions, as discussed below. The intended treatment of such securities in the hands of transferees is unclear.

On March 22, 2012, the U.S. Senate rejected Senate Amendment 1931 to the Act, proposed by Senator Jack Reed, which would have revised the definition of "held of record" to include beneficial owners. Although this amendment was rejected, the Act mandates the SEC to examine its authority to enforce Rule 12g5-1 (definition of securities "held of record") and transmit its recommendations to Congress not later than 120 days after the date of enactment. This will require the SEC to consider how holders should be counted, a matter that presents significant technical issues in view of how equity securities are typically held.

III. Small Issues Exemption

Regulation A in its current form provides an exemption from registration for offerings of up to $5 million per year by U.S. and Canadian non-reporting companies, but the exemption is rarely used because of the low offering cap. Regulation A requires the filing of a simplified offering statement with the SEC, but issuers do not become subject to periodic reporting under the Exchange Act as a consequence of that filing alone.

The Act directs the SEC to amend Regulation A (or adopt a new similar exemption) to exempt from registration offerings of up to $50 million of securities per 12-month period. The new exemption is to be limited to equity securities, debt securities, convertible debt securities and guarantees. The Act does not distinguish between offerings by selling security holders and primary offerings. It also does not set a deadline for the adoption of the exemption.

The exemption will permit issuers to solicit interest in their offerings prior to the filing of any offering statement on terms prescribed by the SEC. Under the exemption, investors are to receive unrestricted securities that can immediately be resold publicly. The civil liability provision in Section 12(a)(2) of the Securities Act is to apply to any person offering or selling securities on the basis of the exemption. In addition to what Regulation A currently provides, issuers taking advantage of the exemption will be required to file audited financial statements with the SEC annually. The Act will also allow the SEC to impose additional conditions, such as periodic reporting requirements, the requirement to file an offering statement with content to be prescribed by the SEC and certain disqualification provisions that mirror those set out in Dodd-Frank.

Securities offered or sold under the new exemption that are either (a) offered or sold on a national securities exchange or (b) offered or sold to qualified purchasers (as defined by the SEC for this purpose) will be exempt from state regulation of the offering process, but the Act preserves state jurisdiction over fraud, deceit or the unlawful conduct by broker-dealers in connection with such transactions. The Act also directs the Comptroller General to conduct a study, within three months of enactment, on the impact of state “blue sky laws” on offerings made under Regulation A.

Because many IPOs in the United States raise less than $50 million in proceeds, the small issues exemption in the Act may have a significant impact on the IPO process, although the extent of that impact will depend in large part on how the SEC exercises its rulemaking authority to define the up-front and on-going obligations of companies that make use of the exemption.

IV. General Solicitation and General Advertising Prohibitions

Rule 506 of Regulation D is the regulatory safe harbor rule under which a company can conduct a “private placement” without limitation as to the dollar amount of the offering. Currently, a company wishing to raise capital in reliance on Rule 506 generally may not offer its securities by any form of general solicitation or general advertising.

The Act directs the SEC, within 90 days of enactment, to revise its rules to remove the prohibition on general solicitation or general advertising for offerings under Rule 506 in which all purchasers are accredited investors and the issuer takes reasonable steps to confirm their accredited investor status. The direction relates only to offerings under Rule 506 and does not by its terms affect other private offerings, such as private placements under other Regulation D exemptions or Section 4(2) of the Securities Act (outside the Rule 506 safe harbor). The Act does not direct that there be a change to the prohibition on "directed selling efforts" in offshore offerings under Regulation S under the Securities Act.

The Act also directs the SEC, within 90 days of enactment, to amend Rule 144A to permit securities sold under Rule 144A to be offered to persons other than QIBs, including by means of general solicitation or general advertising, provided that only QIBs (or persons the seller, or any person acting on the seller's behalf, reasonably believes to be QIBs) purchase the securities.

Notwithstanding these changes, the issuer and other offering participants will remain subject to potential federal securities law anti-fraud liability for whatever is said in the general solicitation or general advertising that is relevant to the offering. Concerns in this area may lead some market participants to continue to observe conventional publicity restrictions, but without the concern that inadvertent general solicitation and general advertising will make Rule 506 or Rule 144A unavailable.

The Act generally provides that, with regard to securities offered and sold in compliance with Rule 506, a person will not become required to register as a broker-dealer solely because that person (i) helps maintain a platform or mechanism that permits such offer or sale, permits general solicitation, general advertising or similar or related activities by issuers of such securities, (ii) co-invests in such securities, or (iii) provides certain ancillary services only with respect to such securities. Important conditions to the relief are that the person does not receive compensation or take possession of customer funds or securities in connection with the purchase and sale of such securities, and is not otherwise subject to a statutory disqualification. The same applies to persons associated with that person. The apparent intent of this new exemption is to aid the development of "angel" networks to support capital formation by small enterprises.

Although private placements conducted in accordance with Rule 506 benefit from federal statutory preemption of state blue sky laws governing the offering process, the same is not true with regard to Rule 144A transactions. Accordingly, it would be prudent to review applicable state blue sky laws regarding restrictions on offers to persons that are not qualified offerees through general solicitation or general advertising in connection with Rule 144A transactions, even though sales will be limited to QIBs.

V. Crowdfunding

The Act will provide a new exemption from the registration requirements of the Securities Act for "crowdfunding," which is a method of capital formation in which groups of people pool money, typically composed of very small individual contributions, and often via internet platforms, to invest in a company or otherwise support an effort by others to accomplish a specific goal. The crowdfunding provisions of the final version of the Act are more focused on investor protection concerns than the version of the Act originally passed by the House of Representatives.

General Exemptions for "Crowdfunding" Transactions

The Act will amend Section 4 of the Securities Act to exempt offerings in which the aggregate amount of securities of an issuer sold within the previous 12-month period is $1 million or less. The Act limits the amount that may be sold to any one investor in reliance on the exemption within a previous 12-month period to (i) the greater of $2,000 or 5% of the investor's annual income or net worth, if the investor's annual income or net worth is less than $100,000 and (ii) 10% of the annual income or net worth of the investor, not to exceed a maximum aggregate amount sold of $100,000 to the investor, if the investor's annual income or net worth is equal to or more than $100,000.

To take advantage of the crowdfunding exemption, issuers must be domestic companies. In addition, issuers may not be reporting companies under the Exchange Act and may not be investment companies as defined in the Investment Company Act of 1940 (the "Investment Company Act") or be excluded from the definition of investment company by Section 3(b) or Section 3(c) of the Investment Company Act.

The Act defines the term "issuer" to include any director, partner, principal executive officer, principal financial officer, controller or principal accounting officer of the issuer that offers or sells a security in a crowdfunding transaction, and any person who offers or sells the security in such offering. This definition presumably was intended to cause the issuer liability provisions of the Act to attach to persons associated with or acting on behalf of the issuer, but it could be problematic when read together with other provisions of the Act (e.g., the requirement that issuers provide their income tax returns or financial statements to potential investors, or the provision stating that the crowdfunding exemption will not apply to any transaction involving the offer or sale of securities by any issuer that is not organized under the laws of a U.S. state or territory).

Companies would be permitted to sell crowdfunding securities without filing a registration statement with the SEC. However, issuers, brokers and funding portals (a new term, discussed below, for a type of permitted intermediary in the offer and sale of crowdfunding securities) must comply with certain requirements for conducting such transactions set forth in the Act, which include providing limited disclosures to the SEC and to potential investors. For example, issuers, brokers and funding portals are required to provide disclosures related to the risks associated with investing in startups and other smaller companies, a description of the business and financial condition of the issuer and the purpose of the offering and the intended use of proceeds. Brokers and funding portals must also take steps to reduce the risk of fraud and ensure that all offering proceeds are only provided to the issuer when the aggregate amount raised is equal to or greater than a target offering amount. For more information on the requirements for conducting crowdfunding transactions, please see Annex A.

The securities sold in crowdfunding transactions will be subject to restrictions on transfer. The purchaser may not transfer such securities within one year unless transferred (i) to the issuer, (ii) to an accredited investor, (iii) as part of an SEC-registered offering, or (iv) to a family member or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the SEC. The SEC may establish other restrictions on transfer by rule.

Requirements for Broker and Funding Portal Registration

Crowdfunding transactions must be conducted through an SEC-registered broker or funding portal. The Act requires an intermediary that offers or sells securities pursuant to this new exemption to register with the SEC as a broker or a funding portal and to register with any applicable self-regulatory organization, such as a national securities exchange. The Act creates a new definition for "funding portal" under the Securities Act: any person acting as an intermediary in a crowdfunding transaction, provided that such person does not (i) offer investment advice, (ii) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal, (iii) compensate employees, agents or other persons for the solicitation or sale of securities displayed on its website or portal, (iv) hold or handle investor funds or securities, or (v) engage in such other activities as the SEC determines appropriate by rule.

The Act directs the SEC to exempt by rule a registered funding portal from the requirement to register as a broker or dealer with the SEC, provided that the funding portal remains subject to the examination, enforcement and other rulemaking authority of the SEC, is a member of a registered national securities association and is subject to other such requirements as the SEC determines appropriate. The Act will require funding portals to be considered brokers or dealers for purposes of national securities association membership, provided that a national securities association may only bring enforcement action against a registered funding portal for a violation of rules of the association written specifically for registered funding portals.

Liability Standards

The Act will create liability for issuers who offer or sell securities in crowdfunding transactions through oral or written communications containing material misstatements or omissions that the issuer cannot prove it did not know about or could not have known about if reasonable care had been exercised. The issuer will be liable to the purchaser for rescission with interest, or damages if the investor sold the securities for less than the purchase price, provided that the purchaser did not know about the misstatement or omission at the time of purchase. The Act will permit the issuer the defenses of loss causation and statute of limitations under Sections 12(b) and 13 of the Securities Act, respectively, as if the liability were created under Section 12(a)(2). The issuer will also be subject to potential federal securities law anti-fraud liability for its oral or written communications.

State Regulation

Securities offered in crowdfunding transactions will be exempt from state regulation of the offering process (i.e., they will be "covered securities" under Section 18 of the Securities Act), but the Act preserves state jurisdiction over fraud, deceit or the unlawful conduct of brokers, dealers, funding portals and issuers. The Act will generally prohibit state securities commissions from requiring any filing or fee with respect to any security offered in a crowdfunding transaction, except for the state securities commissions in the state of the principal place of business of the issuer or in which purchasers of 50% or more of the aggregate amount of the issue are residents. The Act also will generally prohibit any state from enforcing any law, rule or regulation against a registered funding portal, except by states in which the principal place of business of the registered funding portal is located and such law, rule or regulation is not in addition to or different from the requirements for registered funding portals established by the SEC.

Implementation

The Act will allow the SEC 270 days from enactment to issue rules necessary to carry out the crowdfunding provisions of the Act and to define criteria for the disqualification of issuers, brokers and funding portals from making use of the crowdfunding exemption. The disqualification provisions must be substantially similar to the disqualification provisions in Dodd-Frank and must also disqualify any offering by a person that (i) is barred from association with an entity regulated by a state securities commission or from engaging in the business of securities, (ii) has violated any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within the past 10 years, or (iii) has been convicted of a felony or misdemeanor in connection with the purchase or sale of any security.

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Please contact any of our partners and counsel listed under "Capital Markets" in the "Practices" section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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Annex A

Requirements for Conducting "Crowdfunding" Transactions

The Act will require *intermediaries* in a crowdfunding transaction to:

- provide such disclosures, including disclosures related to risks, as the SEC shall determine appropriate by rule;
- ensure each investor (i) reviews investor-education information in accordance with SEC standards established by rule, (ii) positively affirms that such investor understands that the investor is risking the loss of the entire investment and could bear such loss, and (iii) answers questions demonstrating an understanding of the risk associated with startups and other small issuers, the risk of illiquidity and other such matters as the SEC determines appropriate by rule;
- take reasonable measures to reduce the risk of fraud as established by the SEC by rule, including obtaining a background and securities enforcement regulatory history check on each officer, director and greater than 20% shareholder of the issuer;
- not later than 21 days prior to the first day on which securities are sold to any investor, make available to the SEC and to potential investors any information required to be provided by the issuer as described below;
- ensure all offering proceeds are only provided to the issuer when the aggregate amount raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest as the SEC determines appropriate by rule;
- make such efforts as the SEC determines appropriate by rule to ensure that no investor in a 12-month period has purchased securities offered pursuant to this new exemption that, in the aggregate from all issuers, exceed the individual investment limits described above;
- take such steps to protect the privacy of information collected from investors as the SEC determines are appropriate by rule;
- not compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor;
- prohibit its directors, officers or partners from having a financial interest in an issuer using its services; and
- meet such other requirements as the SEC may prescribe.

The Act will require *issuers* in a crowdfunding transaction to:

- file with the SEC and provide to investors and the relevant broker or funding portal and make available to investors:
    - the name, legal status, physical address and website address of the issuer;
    - the names of the directors, officers and greater than 20% shareholders of the issuer;
    - a description of the business and the anticipated business plan of the issuer;
    - a description of the financial condition of the issuer, including, for offerings that have target offering amounts (taken together with all other offerings within the previous 12-month period) of (i) $100,000 or less, income tax returns for the most recently completed fiscal year and financial statements certified by the principal executive officer, (ii) more than $100,000 but not more than $500,000, financial statements reviewed by an independent public accountant using professional standards and procedures or standards or procedures established by the SEC by rule for such purpose, or (iii) more than $500,000, audited financial statements;
    - a description of the purpose of the offering and intended use of proceeds;
    - the target offering amount, the deadline to reach the target offering amount and regular updates regarding the progress of the issuer in meeting the target offering amount;
    - the price to public of the securities or the method for determining such price, provided that prior to sale each investor is provided in writing with the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
    - a description of the ownership and capital structure of the issuer, including (i) the terms of the securities being offered and each other class of security of the issuer, including how such terms may be modified and how the rights of the class of securities being offered may be limited, diluted or qualified by another class, (ii) how the exercise of rights held by the principal shareholders could negatively impact the purchasers of securities being offered, (iii) the name and ownership level of existing shareholders who own more than 20% of any class of securities of the issuer, (iv) how the securities being offered are being valued now and examples of how they may be valued in the future, and (v) the risks associated with minority ownership, corporate actions such as additional issuances of shares, a sale of the issuer or its assets or related party transactions; and
    - such other information as the SEC may prescribe by rule for the protection of investors;

- not advertise the terms of the offering, except for notices that direct investors to the broker or funding portal;

- not compensate any person to promote its offerings through communication channels provided by a broker or funding portal without taking such steps as the SEC shall require by rule to ensure that such person clearly discloses the receipt of such compensation upon each communication;

- file with the SEC and provide to investors at least annually reports of the results of operations and financial statements of the issuer, as the SEC shall determine appropriate by rule; and

- comply with such other requirements as the SEC may prescribe for the protection of investors and in the public interest.

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