

The JOBS Act – Crowdfunding and Beyond

By Ron Kitchens and Phillip D. Torrence

SOCIAL NETWORKING MEETS ANGEL INVESTING

For businesses looking for startup funding, the Jumpstart Our Business Startups Act or JOBS Act signed into law by President Barack Obama on April 5, 2012 offers a new pot of gold under the proverbial rainbow. Rather than asking family members for a few seed dollars or packaging up a business plan and heading off to a bank or other credited financial institution for a formal loan, entrepreneurs can appeal to the “crowd” for funding. Using social media networks like Facebook, Twitter or LinkedIn to get a message out, Crowdfunding, defined as the use of small amounts of capital from a large number of individuals, can support entrepreneurship by exponentially increasing an entrepreneur’s ability to finance a new business and having cash available on day one.

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the jobs act —

CROWDFUNDING AND BEYOND

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Economic development as a practice and profession dates back at least 2200 years to the Roman Empire when the Roman Senate granted tax abatements to merchants using the Port of Delos. Over these past 22 centuries, economic development has pretty much remained the same: a community or governmental-based group focusing on selling location, natural resources, and labor. The business of economic development has always been closely controlled and managed due to confidentiality, competition, and scarcity of opportunity.

While a command and control strategy may have served the profession well in the past, it will not in the future. As large projects that are dependent on natural resources and location become even scarcer, collaboration and crowdfunding will be the mantra for the future. One example of the potential power of an open source economy is the recently signed federal JOBS Act, www.gpo.gov/fdsys/pkg/BILLS.../pdf/BILLS-112hr3606enr.pdf, which creates a new playing field and rules for economic development. Those places that adapt to the new reality will be those that thrive; those that fail to adapt risk being a footnote in history.

For those communities looking to establish an entrepreneurial environment, crowdfunding opens up a new “port of entry” for sustainable business ventures. As long as a company is looking to raise less than \$1 million, the JOBS Act removes seemingly insurmountable mountains of paperwork that most entrepreneurs are not qualified or willing to take the time to answer. As most typical startups can successfully get going with as little as \$25,000, the worldwide web can easily help the budding en-

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trepreneur to find 1,000 people who are willing to give \$25 for a “little return.” Although getting that little return is a risk, the small amount initially invested is viewed as a moderate investment by most.

When President Obama signed the JOBS Act into law, it was designed to increase job creation and economic growth by improving access to public capital markets for emerging growth companies. The JOBS Act’s purpose is to drive the creation of jobs in America by removing access barriers to capital for U.S. and non-U.S. companies from both public and private sources.

The JOBS Act makes significant changes to the securities laws and focuses on streamlining the initial public offering (“IPO”) process by reducing some of the costs and burdens of going public. While important provisions of the JOBS Act will go into effect immediately, other provisions will require further rulemaking by the Securities and Exchange Commission (“SEC”).

What led us here? There were so many obstacles and upfront costs to funding new ideas with the old and staid methods that it discouraged most to participate. The average IPO in the U.S. costs more than several million dollars in up-front fees and costs to have the first right to sell shares of a

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SOCIAL NETWORKING MEETS ANGEL INVESTING

For businesses looking for startup funding, the Jumpstart Our Business Startups Act or JOBS Act signed into law by President Barack Obama on April 5, 2012 offers a new pot of gold under the proverbial rainbow. Rather than asking family members for a few seed dollars or packaging up a business plan and heading off to a bank or other credited financial institution for a formal loan, entrepreneurs can appeal to the “crowd” for funding. Using social media networks like Facebook, Twitter or LinkedIn to get a message out, Crowdfunding, defined as the use of small amounts of capital from a large number of individuals, can support entrepreneurship by exponentially increasing an entrepreneur’s ability to finance a new business and having cash available on day one.

company to the public with limited general solicitation allowed. Crowdfunding, the collective process of capital gathering or people pooling their money or resources together, usually via the Internet or social media outlets to support the efforts of others, will allow private investors who were previously shut out of angel and startup funds to participate. Social sharing of great new ideas is contagious. Multiple social media platforms spanning the world have been developed with billions of participants.

The crowdfunding law change will unleash the enormous power of social media to mate good ideas led by good people with capital. As a result, the small entrepreneur with little resources to start will now have greater access to capital. Economic growth is driven by innovation. Innovation is driven by experimentation. Crowdfunding funds experimentation. Let's take a look at some of the significant portions of the JOBS Act that will impact our local economies.

ACCESS TO PRIVATE CAPITAL

One of the primary goals of the JOBS Act was to make it easier for private companies to raise capital by amending the Securities Act and Exchange Act and requiring the SEC to amend its rules and regulations as follows:

- The SEC is to revise Rule 506 of Regulation D and Rule 144A to eliminate the prohibitions on general solicitation and general advertising in private offerings conducted pursuant to these rules. Previously, companies using the Rule 506 Exemption were allowed to raise an unlimited amount of money if they did not use general solicitation, advertising, or fraudulent materials to market securities by simply fulfilling the requirement of filing Form D, a brief notice including the names and addresses of owners and stock promoters. Rule 144A provided a safe harbor from the registration requirements of the Securities Act of 1933 by allowing large institutional investors to trade restricted securities among themselves, thus eliminating restrictions imposed to protect the public.
- The Securities Act will be amended to provide that trading platforms (software through which investors can open, close, and manage portfolios offered by brokers in exchange for maintaining a funded account and specified number of trades per defined period) involved with the sale of securities in a Rule 506 private placement are not subject to registration as a broker or dealer as long as certain conditions are met (including the condition that no such person receives compensation in connection with the purchase or sale of securities and that the platform does

not have possession of customer funds or securities in connection with the purchase or sale of securities).

- The SEC will increase the amount of securities that can be issued in a 12-month period under Regulation A which regulates whether offerings of \$5 million or less can qualify for simplified registration from \$5 million to \$50 million (or promulgate a new Regulation A-like exemption from registration similar to Regulation A permitting such increased amounts).
- The Exchange Act will be amended to raise the registration trigger at which private companies are required to register a class of securities and become subject to public company reporting obligations (shareholder thresholds will increase to 2,000 holders of record or 500 persons who are not accredited investors, excluding shareholders who acquired securities through an employee compensation plan or in connection with the crowdfunding exemption).

Private companies that sell equity securities (instruments that show an ownership position – shares – in a corporation that is relative to the corporation's assets and profits – outstanding shares) to venture, angel or private equity investors have long relied on an exemption from public registration, Rule 506 of Regulation D. This exemption permits sales of shares to sophisticated investors subject to certain limitations, including that the company not engage in "general solicitation" or advertising of the offering. The JOBS Act expands Rule 506 to permit general solicitation and advertising for private offerings under Rule 506 if all purchasers qualify as "accredited investors" under SEC rules.

Startups have increasing access to tools that allow them to communicate with large numbers of potential investors, including blogs, e-mail newsletters, and investing communities. By lifting the restriction on general solicitation, entrepreneurs will be able to use these tools and others to announce their intentions to raise funding without a concern that they are undermining their ability to rely on Rule 506.

Essentially, entrepreneurs can advertise the existence of the offering to the general public, which may help them reach potential investors who would not otherwise have known about the offering. However, in order to stay within the boundaries of a Rule 506 private offering, they cannot sell to the general public – if they engage in general solicitation, all purchasers must be accredited investors.

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In the U.S. now, there are approximately 60,000 angel investors, individuals who provide financial backing for small-startups usually through a one-time payment of seed money and are typically family members or friends of the entrepreneur. Crowdfunding is likely to create 60 million new angel investors in the U.S. alone.

Defined by the SEC under Regulation D, accredited investors include individuals, banks, insurance companies, employee benefit plans, and trusts that are financially sound and have a reduced need for protection by government filings. Accredited investors are classified as an individual having an income of more than \$200,000 per year (or \$300,000 jointly with a spouse) for the past two years, having a net worth exceeding \$1 million, or being a general partner or officer of the investment being offered.

Entrepreneurs should consider what types of solicitation and advertising are appropriate for their businesses. Entrepreneurs may want to consider what impact, positive or negative, any such solicitation or advertising may have on the entrepreneur's or company's image or credibility, the company's operations, and ability to attract appropriate investors.

CROWDFUNDING

In the U.S. now, there are approximately 60,000 angel investors, individuals who provide financial backing for small-startups usually through a one-time payment of seed money and are typically family members or friends of the entrepreneur. Crowdfunding is likely to create 60 million new angel investors in the U.S. alone. This is a powerful transformational development that alters the landscape of financing forever as companies looking for funding in the neighborhood of \$5,000 to \$500,000 can draw from a larger pool of investors offering much smaller investment amounts, which can range anywhere from \$25 to \$2,000 depending on the investment.

Peers that believe in inventors and entrepreneurs and their startups will likely fund good ideas expressed by people that gain trust quickly. Since most crowdfunding investments will be small, it will enable new experiments to be tried. With micro-financing, testing new ideas and testing new investments can be done with a minimization of individual pain in the case of failure. People may gamble a \$25 bet on a long shot that normally would never get funded if the minimum investment venture capital style was expected to be \$250,000. Some of these long shots that get funded by crowdfunding, that would have never received funding with the old financing paradigm, are going to be the ones that change our world for the better.

Crowdfunding is going to be a tool for people to invest in their own communities. This type of helping hand support to people in your own communities will help create sustainable economic health. Crowdfunding will likely be teamed with crowdsourcing of information and resources. Every enterprise will become an exercise in the power of collaborative communities. Crowdfunding has the potential to do more than anything before in getting more people than ever excited to go into work each day.

Here is how crowdfunding works under the JOBS Act. Securities laws will be amended to provide a new "crowdfunding" exemption from registration, meaning that private companies will be allowed to raise up to \$1 million over a 12-month period from an unlimited number of investors, including unsophisticated investors, through "crowdfunding." The specific requirements for the crowdfunding exemption are as follows:

- The aggregate dollar amount of securities that an issuer (a domestic or foreign government, corporation or investment trust that develops, registers, and sells securities for operational financing) can sell in a crowdfunding transaction is up to \$1 million over a 12-month period.
- Individual investor limits, limiting the amount an issuer can sell to an individual investor in any 12-month period, will be limited to the maximum of (i) the greater of \$2,000 or 5 percent of the annual income or net worth (for investors whose net worth or annual income is less than \$100,000), and (ii) 10 percent, not to exceed \$100,000, of annual income or net worth (for investors whose annual income or net worth is equal to or greater than \$100,000).
- Issuers utilizing the crowdfunding exemption to raise capital must sell the securities through an intermediary (either a registered broker or a person registered with the SEC as a "funding portal").
- Issuers must make financial and other information available to both the SEC and investors, both in connection with the offering and on an annual basis, under a disclosure regime (a transparent and structured reporting system) that enhances the disclosure and likely increases the expense with the size of the offering.

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STREAMLINED IPO PROCESS

The JOBS Act will significantly streamline the IPO process, making it more attractive for “emerging growth companies” (“EGCs”) to go public. An EGC is a company with less than \$1 billion in annual gross revenue during its most recent fiscal year (other than any such company that first sold common equity securities in a transaction registered with the SEC prior to December 8, 2011). It should be noted that, in addition to not necessarily being “emerging” or “growing,” EGCs are not particularly small companies. According to industry sources, over 90 percent of the companies that conducted IPOs in 2012 had annual revenues of less than \$1 billion.

With this streamlined IPO process, crowdfunding will offer expanded investment opportunities for investors and help bring new and innovative products to the market that otherwise might not have been possible with the old regulations. The process of accelerating EGCs for economic developers could move much faster as connecting local opportunities with local money just got easier.

Everyone wants to improve the communities they live in, particularly if their pocketbooks have the opportunity to profit financially by doing so. Crowdfunding sites that offer local investment opportunities will have a strategic advantage over those that offer investment opportunities far away as due diligence can be performed more easily. In addition, cities and states with accredited research universities in their midst will have the added benefit of having an established pipeline for startups and EGCs based on research. Lastly, investors who live near the location of a startup or EGC investment offered through crowdfunding have opportunity to meet the entrepreneur and literally watch their investment being built from the ground up.

Under the JOBS Act, EGCs will benefit from the following changes to the IPO process:

- EGCs will be able to make pre-filing (oral or written) solicitations of interest, requests made to prospective investors that involve no monetary obligation or commitment until a final offering by the issuer, to qualified institutional buyers and accredited investors (within the meaning of Rule 144A and Regulation D, respectively) to determine whether such investors might have an interest in a contemplated IPO or other securities offering.
- EGCs will be permitted to submit a “quiet” draft registration statement (preliminary prospectus of pertinent information to shareholders filed by a firm prior to proceeding with an initial public offering of

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securities) to the SEC for a confidential nonpublic review, provided that such draft registration statements are publicly filed no later than 21 days before the date on which the issuer conducts a road show.

- EGCs will need only two (rather than three) years of audited financial statements in their registration statements to go public.
- Brokers or dealers will be permitted to publish/distribute research reports covering an EGC prior to or following the filing of a registration statement even if the broker or dealer will participate in the offering.
- The JOBS Act also requires the SEC, within 180 days of the JOBS Act’s adoption, to conduct a review

of the disclosure rules contained in Regulation S-K which lays out reporting requirements for various SEC filings used by public companies, in order to update, modernize, and simplify the requirements of the IPO registration process for EGCs.

We have all seen the media feeding frenzy around the initial filing of the registration statements by high profile companies like LinkedIn, Zynga, Groupon, and Facebook, as various journalists, analysts, and other commentators combed through them for financial information, compensation data, and other insights on their businesses.

We have further seen how the SEC

review process has led some companies to modify the way they present key business metrics or accounting information.

Under the new rules, companies may initiate the review process with SEC examiners without releasing the full registration statement to the public, and may be able to resolve presentation and disclosure issues confidentially with the SEC before disclosing their registration statement to the public. Additionally, for entrepreneurs contemplating an IPO, the ability to rely on scaled disclosure and more limited governance obligations should reduce the costs of going public.

IPO “ON-RAMP” FOR EGCs

The JOBS Act will also create a simplified entrance or “on-ramp” to access the public capital markets for EGCs by phasing in certain public company disclosure requirements over time. Once public, an EGC will have a limited transition period of one to five years (depending upon the size of the EGC) during which the regulatory requirements will be relaxed in order to reduce the cost of compliance. During such transition periods, an EGC will be:

- Exempt from Section 404(b) of the Sarbanes-Oxley Act of 2002 passed by the U.S. Congress to pro-

protect investors from the possibility of fraudulent accounting activities by corporations in response to accounting scandals like Enron, which requires auditor attestation of internal control over financial reporting on Form 10-K.

- Exempt from the detailed narrative disclosure requirements of compensation discussion and analysis.
- Exempt from the executive compensation voting requirements of the Dodd-Frank Wall Street Reform Act of 2010 which increased government oversight of trading in complex financial instruments restricting the type of proprietary trading activities that financial institutions are allowed to practice with the intent of preventing major collapses, including the requirement for say-on-pay, say-on-frequency and say-on-golden parachute shareholder votes and the executive compensation disclosure provisions requiring the pay-for-performance graph and CEO pay ratio disclosure.
- Exempt from complying with new Generally Accepted Accounting Principles (GAAP) pronouncements otherwise applicable to public companies until the pronouncements become applicable to private companies. These new GAAP principles require significant disclosure and expand the definition of a “service” being offered to a customer as anything that has value. Their purpose is to give financial statement users a better picture of how a company is earning its money.
- Exempt from any rules that the Public Company Accounting Oversight Board may adopt relating to mandatory audit firm rotation and any requirement to include an auditor discussion and analysis narrative in the audit report.
- Permitted, with some exceptions, to “opt in” and comply with the disclosure rules otherwise required of issuers under the federal securities laws on an “a la carte” basis.

The “on-ramp” provisions of the JOBS Act are structured as amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, which took immediate effect upon signing by the President. There will likely be transition and implementation issues that EGCs and their counsel will have to address until the SEC has

Although the JOBS Act moved quickly through Congress, it will take time to evaluate what impact it will have on investors and the scope of companies able to take advantage of its provisions. Nevertheless, the “on-ramp” established by the JOBS Act will likely make the IPO process significantly more attractive to most U.S. and non-U.S. issuers seeking to access the U.S. capital markets and should provide many newly created public companies with an eased transition to the public company regulatory regime.

had an opportunity to issue interpretative guidance and update the rules currently promulgated under such acts.

The staff of the Securities and Exchange Commission’s Division of Corporation Finance has already provided guidance regarding the initial procedures EGCs should use to furnish draft registration statements to the SEC for confidential nonpublic review. This guidance is available at <http://www.sec.gov/divisions/corpfin/cfanouncements/draftregstatements.htm>. Eligible companies may begin making such submissions immediately.

IMPACT OF THE JOBS ACT

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Over the past 10 years and since the adoption of the Sarbanes-Oxley Act of 2002, the IPO alternative for many domestic venture capital-backed companies has been closed. Over the past several years, many of our domestic venture capital-backed medical device and life science companies have found opportunities on foreign stock exchanges such as the Australia Stock Exchange (ASX) and the London Stock Exchange.

For the large group of companies that are expected to fall into the category of EGCs in the future, the effect of the JOBS Act is to repeal wide swaths of Dodd-Frank, Sarbanes-Oxley, and other reform legislation, as well as longstanding public company disclosure requirements. Ironically, many of these “impediments” to capital formation were implemented in the last decade to address perceived failings in regulation identified in the wake of the dot-com bust, the Enron scandal, and the most recent financial crisis.

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Crowdfunding offers an interesting new method of funding outside of traditional angel or institutional investors. However to the extent that, through crowdfunding, a company finds itself with a large base of unsophisticated investors, the company should expect to spend substantial time and resources related to the administration and communication challenges inherent in that type of shareholder base. For example, items such as shareholder actions may be more challenging to manage and may require more detailed communication or extended time to complete.

While there is no “magic bullet” or “one size fits all” approach to economic development, it is clear that the practices, plans, and perceptions that built our nation, states, and communities will no longer build our economies. To build vibrant business communities, collaboration and capital formation must rise to the top of our strategies.

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Our great nation is about to enter a period of economics, where the power “of many” or crowdsourcing has the ability to chart a new future for people struggling to make their start or yearning for empowerment. For example, just think of what organizations have been able to do like Kiva (www.kiva.org) for entrepreneurs around the globe looking to cast aside poverty or Kickstarter (www.kickstarter.com) for independently crafted projects. Capital is about to become boundaryless and available to great opportunities anywhere. Those communities which figure out how to harness this power will thrive into the next century and beyond. 🌐

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