# The JOBS Act: Implications for Broker-Dealers

On March 27, 2012, the House of Representatives passed the Jumpstart Our Business Startups Act (the "**JOBS Act**"), in the same form passed by the Senate on March 22, 2012.[1] The JOBS Act will now go to President Obama for his signature. If enacted, the JOBS Act will have a significant impact on intermediaries participating in both public and private capital raising efforts.

Our March 26, 2012 Client Memorandum explored the broader capital markets changes from the JOBS Act. This memorandum takes a more detailed look at those aspects of the JOBS Act of particular significance to broker-dealer regulation and equity market structure, focusing on those that would:

- create new limited exemptions for particular securities intermediaries from broker-dealer registration,
- require the SEC to reexamine its move toward decimalization, and
- force FINRA to revise its rules governing the issuance of research and the conduct of research analysts in connection with certain initial public offerings ("**IPOs**").

## Regulation D Offering Platforms

The JOBS Act requires that the SEC amend Rule 506 under Regulation D to permit an issuer to widely market an offering using general solicitation, so long as all purchasers in the transaction are accredited investors. In connection with this new expanded ability to broadly market formerly "private" offerings, such as through the Internet, the JOBS Act creates a new exception from broker-dealer registration requirements for platforms that aim to facilitate offerings under Rule 506 of Regulation D ("**Reg D Offerings**").

Specifically, in connection with a Reg D Offering, a person would not be required to register as a broker-dealer solely because it engages in any of the following activities:

- the person maintains a "platform or mechanism" that permits offers, sales, purchases, negotiations, general solicitations or similar activities in connection with a Reg D Offering,
- the person or its associated person co-invests in the Reg D Offering, or
- the person or its associated person provides ancillary services, such as due diligence and documentation, in connection with the Reg D Offering.[2]

To be eligible for this exemption, the person and its associated persons:

- may not receive any compensation in connection with a purchase or sale in the Reg D Offering,
- may not have possession or control of customer funds or securities in connection with a purchase or sale in a Reg D Offering, and

[1] Please see Davis Polk's March 9, 2012 Client Memorandum for a summary of an earlier version of the bill passed by the House. This summary remains accurate other than with respect to the crowdfunding provisions described in note 4 below.

[2] "Ancillary services" is defined as (i) due diligence services in connection with the Reg D Offering, so long as they do not include investment advice or recommendations for separate compensation, and (ii) providing standardized documents to issuers and investors, so long as the person does not negotiate the offering terms and the standardized documents are not required.

- may not be subject to statutory disqualification, as defined in the Securities Exchange Act of 1934 (the "**Exchange Act**").

The exemption appears to be primarily intended for online platforms like AngelList, which facilitate private transactions between startup companies and investors, but do not charge a fee. However, "platform or mechanism" is undefined, and appears to include in-person contacts, which suggests that it includes more than electronic systems. Nonetheless, the restriction on receipt of compensation may limit the utility of the exemption for most firms.[3]

## Crowdfunding Intermediaries

The JOBS Act creates a new exemption from registration under the Securities Act of 1933 (the "**Securities Act**") for qualified "crowdfunding" transactions.[4] In order for a transaction to be eligible for the exemption, among other things, it must be conducted through a broker or "funding portal" that fulfils certain obligations in connection with the transaction, such as providing risk disclosures to investors.

A "funding portal" is a new intermediary category created by the JOBS Act. It is defined as a person that acts as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to the new crowdfunding exemption under the Securities Act. Like "platform or mechanism," it is unclear that a funding portal must be an electronic system, rather than a manual brokerage operation. However, qualification as a funding portal is subject to a number of conditions, including restrictions on:

- offering investment advice or recommendations,
- soliciting offers or transactions,
- compensating employees, agents or other persons for solicitation or based on the sale of securities,
- holding, managing or possessing investor funds or securities, and
- other restrictions the SEC may apply by rule.

A funding portal would be required to register as such with the SEC, but would be conditionally exempt from registration as a broker-dealer. Specifically, the SEC would be required to adopt rules exempting funding portals from registration as a broker-dealer under Section 15(a) of the Exchange Act, provided that the funding portal (i) is a member of a registered national securities association, (ii) remains subject to SEC examination, enforcement and rulemaking authority, and (iii) meets such other requirements that the SEC deems appropriate.

A broker or funding portal acting as an intermediary in a crowdfunding transaction would be required to be registered as such with the SEC and any applicable self-regulatory organization, and to comply with a host of requirements in connection with each crowdfunding transaction it intermediates. These include:

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[3] The exact language prohibits compensation "in connection with the purchase or sale of such security." There may be an interpretive question as to whether a platform could charge a flat fee to access (unrelated to any particular transaction) and still qualify for the exception.

[4] Under the final version of the JOBS Act passed by both the House and Senate, subject to various conditions, a transaction would be exempt from registration under Section 5 of the Securities Act if the total aggregate amount of securities sold by an issuer during any 12-month period is not more than $1 million, and the amount sold to any investor during a 12-month period is (i) for investors with less than $100,000 in net worth or annual income, the greater of $2,000 or 5 percent of their annual income or net worth, and (ii) for investors with greater than $100,000 in annual income or net worth, up to 10 percent of the investor's annual income or net worth, not to exceed $100,000.

- providing disclosures that the SEC determines appropriate by rule, including regarding the risks of the transaction and "investor education materials,"
- "ensuring" that each investor (i) reviews the investor education materials, (ii) affirms both that the investor understands the risk of loss and can bear the loss, and (iii) answers questions that demonstrate that the investor understands the risks of the investment,
- taking measures to reduce the risk of fraud, including conducting background checks on principals of each issuer,
- at least 21 days before any sale, making available to investors and the SEC any disclosures provided by the issuer,
- ensuring that an issuer receives offering proceeds only once it has reached the target offering amount, and allowing all investors to cancel their investment commitments, and
- making efforts to ensure than each investor has not exceeded the 12-month limit on their aggregate crowdfunding investments in all issuers.

It is unclear whether funding portals will be able to comply with these requirements in the near future. The SEC is required to adopt rules implementing the provisions within nine months, but is months behind on many of the deadlines imposed by the Dodd-Frank Act. Moreover, because the JOBS Act limits a national securities association's power to examine and enforce its rules on its funding portal members to only those rules "specifically written for registered funding portals," FINRA will need to modify its rules to accommodate the registration and regulation of funding portals. This would effectively require that FINRA create a new, separate registration category and rulebook for funding portal members. Alternatively, an entirely new national securities association specific to funding portals would need to register with the SEC and adopt rules for its members.

## Decimalization

The JOBS Act directs the SEC to conduct a study regarding the impact that quoting in penny increments has had on (i) the number of IPOs, (ii) liquidity for the securities of small and middle capitalization companies and (iii) whether, at penny increments, there is "sufficient economic incentive" for market makers to support trading in these securities.[5] The SEC has 90 days from enactment to conduct the study. The JOBS Act also gives the SEC discretionary authority, based upon the results of its study, to pass rules within 180 days of enactment that would increase the minimum trading increment for securities of emerging growth companies to up to $0.09 cents. We believe that 90 days is insufficient to perform the level of analysis that this topic requires, and thus the SEC is likely to prepare an interim report, to be followed by further study of the impact of penny trading increments before taking any steps that would increase spreads and investors' costs.

## Research on Emerging Growth Companies

The JOBS Act seeks to ease the path to an IPO for issuers with less than a billion dollars of revenue, called "emerging growth companies" (or "**EGCs**"), by creating various special exemptions from existing securities laws or rules in the context of an EGC's IPO. With respect to research on EGCs undergoing an IPO, the JOBS Act:

[5] Some have argued that the decline in the number of IPOs can, in part, be attributed to the SEC's move toward decimalization—which they argue reduced broker-dealers' economic incentive to make markets in less liquid stocks, such as those of smaller companies. *See*, *e.g.*, IPO Task Force, Rebuilding the IPO On-Ramp (Oct. 20, 2011) at 13.

- Exempts a "research report"[6] about an EGC from being considered to be an "offer" for purposes of (i) the research being deemed a prospectus or (ii) the broker issuing the research report violating the prohibition on making an offer before a registration statement has been filed. These exemptions would apply even where the research report is issued by a firm participating in the IPO.[7]
- Prohibits the SEC or FINRA from maintaining any rules, in the context of an EGC's IPO, that would either (i) restrict based on functional role, which associated person of a broker-dealer may arrange for communications between a research analyst and a potential investor, or (ii) restrict a research analyst from participating in communications with management of an EGC, solely because non-research personnel also participate in the communication.
- Prohibits the SEC or FINRA from maintaining any rules, in the context of an EGC's IPO, that would prohibit a broker-dealer from publishing a research report or making a public appearance within any quiet period following the IPO or the expiration of a lock-up agreement.

The implications of these provisions are discussed in more detail in our March 26, 2012 Client Memorandum.

[6] The JOBS Act would broadly define "research report" for purposes of this exemption as "a written, electronic, or oral communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."

[7] To the extent applicable, FINRA rules relating to the issuance of a research report, such as the requirements applicable to sales literature under NASD Rule 2210 and those requirements under NASD Rule 2711 not affected by the JOBS Act, would continue to apply.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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