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Los Angeles lawyer Mark Hiraide analyzes the regulatory regime and impact of the Jumpstart Our Business Startups (JOBS) Act

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by Mark Hiraide

READY CAPITAL

While the JOBS Act makes it possible for nearly anyone to raise venture capital, it also raises the stakes for business attorneys as gatekeepers

THE FINAL stages of a major shift in federal securities laws took place in May 2016 when entrepreneurs and companies gained unprecedented access to capital. For the first time in the history of federal securities regulation in the United States, businesses may raise capital from the general public without registering a securities offering with the Securities and Exchange Commission and state securities regulators. This expansion of the funding universe is due to the Jumpstart Our Business Startups (JOBS) Act of 2012,[1] designed to spur job creation by easing regulations governing "private" securities offerings to help early-stage companies grow. The JOBS Act removed previous restrictions on advertising securities offerings. Under the new law it is significantly easier for entrepreneurial clients to fund their ventures using other people's money (OPM). However, lawyers must remain vigilant as regulators view lawyers as the gatekeepers who will fill in the regulatory void.

The JOBS Act legalized equity crowdfunding,[2] fostered private peer-to-peer lending, created a new regime for regulating mini-IPOs, and paved the way for the SEC to create new sources of liquidity for early-stage investors through secondary "venture markets." The law already has spawned new and innovative financial intermediaries dispensing capital to startup and growing businesses. It has been heralded as "democratizing" access to capital by "disintermediating" Wall Street from the process of selling securities.[3] Many hail the JOBS Act, in particular its provisions for equity crowdfunding, as allowing everyday people to invest in an asset class previously reserved for venture capitalists. Crowds of small investors now may directly fund startup businesses that pique their interest. Yet there is concern that the new regime for raising capital from unsophisticated investors lacks sufficient investor protections.[4]

The JOBS Act's elimination of the regulatory burdens on private offerings, and the associated reduction in cost, will make public capital markets attractive to many. No longer will equity financing be reserved for those few with the resources to attract and engage Wall Street investment bankers and lawyers.

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MICHAEL CALLAWAY


U.S. SECURITIES AND EXCHANGE COMMISSION
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This "Uberization" of capital markets[5] will make capital more readily accessible to every budding entrepreneur, and it will have significant ramifications for the practice of business law.

A growing awareness of access to capital by the public will lead to a demand for legal services. Lawyers have an opportunity to expand their business practices, but they will need to better understand the specialized field of securities law. The new laws and rules raise many new questions, the answers to which often are informed by years of old interpretations and customary practices in the law of corporate financing transactions. Today's business lawyers must have at least a working knowledge of the new methods and rules for raising capital under Regulation CF (crowdfunding), Regulation D, and Regulation A under Titles II, III, and IV of the JOBS Act. They must understand the interplay between federal and state securities laws. They must advise clients about the often draconian statutory liabilities under those laws. And they must be clear about their role as securities lawyers and the liabilities they assume.

When Congress enacted the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act) and created the Securities and Exchange Commission, the business of raising investment capital—taking OPM—became subject to extensive regulation. The federal securities laws, and each state's "blue sky" securities laws, mandate that all offers and sales of securities be registered with the SEC and qualified with state securities regulators unless exempt from such registration.

Prior to the JOBS Act, the most common exemption from registration was for nonpublic securities offerings,[6] which placed strict limitations on soliciting investors and advertising the offering. The SEC and the courts had long interpreted the nonpublic offering exemption to prohibit any form of general solicitation.[7] They did not, however, set forth clear guidelines for determining what constituted a general solicitation. The Supreme Court in 1953 outlined the contours of what constitutes a private offering for purposes of the exemption. In *SEC v. Ralston Purina Co.*, the Court examined the knowledge of the investor and its relationship with the issuer as a basis for distinguishing a private offering from a public offering.[8] The boundaries, however, were far from clear. Prior to the SEC's promulgation of Regulation D in 1982, many members of the securities bar were uncomfortable rendering "no registration" opinions. Even after Regulation D, until the enactment of the JOBS Act, issuers, who in litigation bear the burden of proving an exemption from registration, typically restricted their unregistered offerings to prospective investors with whom they could demonstrate a "pre-existing substantive business relationship."[9]

In recent years, organized groups of individuals with high net worth (angel investors) have been a source of early-stage capital, but attracting the attention of angel investors is nearly impossible without some initial seed capital to validate or prove a business model or product. The only other alternative for raising capital—soliciting the public—required registering the securities offering with the SEC, the same process undertaken by companies going public through an initial public offering (IPO). Registration is cost-prohibitive for most early-stage companies.[10] Even if a company could afford the legal and audit fees charged for public offerings, after the dot-com crash in the early 1990s, the public equity markets became inhospitable for early-stage small (less than $50 million) IPOs. Changes in market regulation, including the decimalization and deregulation of commissions, shrinking profits of smaller investment banking firms, increased regulation of those investment banking firms by the Financial Industry Regulatory Authority (FINRA) in response to microcap stock frauds, and other structural changes to the industry, resulted in the exodus of regional investment banking underwriters to small public offerings.[11]

The Securities Act's restrictions on soliciting investors—well-intentioned in the aftermath of the stock market crash of 1929 and the Great Depression—made the ambition of successfully raising capital for startups unattainable for most people. It relegated entrepreneurs to raising seed capital from friends, family, and others with whom the entrepreneur had the requisite relationship.[12] Small issuers were frequently unable to comply with Securities Act provisions because of a combination of exorbitant costs, unworkable resale provisions, ambiguity, and taint of prior illegal stock sales.

Consequently, an entrepreneur's parents, family, and friends, and the geographic neighborhood in which one lived were significant factors in determining who received funding, who became owners of a business, and what demographic eventually accumulated capital and wealth in this country. To close the capital gap for early-stage financing, stimulate job growth, and address issues of unequal access to capital, in 2012, President Obama signed into law the JOBS Act. In relaxing the restrictions on soliciting investors, the new law reflects the advent of the Internet, modern communication technology, and social media, which made the 90-year-old restrictions on advertising securities offerings increasingly impractical.

The JOBS Act dramatically changed the rules relating to private securities offerings by creating three new methods of conducting public offerings that are exempt from SEC registration. These offering exemptions are found in Titles II, III, and IV of the JOBS Act and are often referred to by these JOBS Act titles. The differences among the three exemptions relate to the size of the offering, investor qualifications, and manner in which the securities may be offered. The new exemptions from registration afforded by Title II and Title IV allow unrestricted general solicitation of investors; in effect, they permit unregistered public offerings. Title III provides a new exemption for selling securities through crowdfunding. All three exemptions preempt certain aspects of state blue sky securities law regulation.

Title II: Rule 506(c) of Regulation D

Title II of the JOBS Act dramatically changed the rules for raising capital from accredited

State Blue Sky Laws

"Blue sky laws" are state laws regulating the offer and sale of securities. The term originated from the Supreme Court's description of fraudulent securities as "speculative schemes which have no more basis than so many feet of 'blue sky.'"[1] Although many states have adopted some form of the Uniform Securities Act drafted by the National Conference of Commissioners of Uniform State Laws, others, including California, have not adopted the uniform act and have their own unique securities law. Many of these state securities laws provide the state securities regulator with the authority to deny a securities offering based on the merits of the terms of the securities. California is one such "merit review" state, and the commissioner of the Department of Business Oversight must make a finding that an offering is "fair, just and equitable" before she will issue a permit to allow sale of the securities in California. A principal feature of the JOBS Act is its preemption of blue sky laws for certain securities offerings. However, federal preemption under the JOBS Act is limited. In most cases, it does not preempt state regulation of offers and sales by shareholders (i.e., secondary transactions) or state broker-dealer registration requirements. Similarly, each state blue sky statute provides investors with statutory civil rescission remedies that are not subject to federal preemption.

[1] Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).

investors who, in the case of an individual, is a person with 1) an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, or 2) a net worth in excess of $1 million excluding home equity.[13] Title II amended Rule 506 of Regulation D by adding new paragraph c, which eliminated completely the prohibition on general solicitation. This means that a company can widely advertise its offering as long as it takes "reasonable steps to verify" that investors are accredited, "using such method as determined by the Commission."[14] Issuers must have a reasonable belief that all purchasers are accredited investors.[15] Prior to Title II of the JOBS Act, which went into effect in September 2014, issuers customarily relied on self-certifications, or check-the-box certifications as to accreditation. Self-certifications will not satisfy the new verification requirement applicable to public offerings under Rule 506(c).

Rule 506 of Regulation D has become the cornerstone of the regulatory regime for nonregistered offerings. The rule provides bright line "safe harbor" rules to establish an exemption from SEC registration. In 1996, Congress addressed the duplication of dual federal and state securities regulation in the National Securities Markets Improvements Act of 1996,[16] and preempted state blue sky registration or qualification of federal covered securities, i.e., those offered in compliance with Rule 506 of Regulation D. In addition to federal preemption, the absence of any limitation in Rule 506 on the offering amount and number of investors as well as absence of specific disclosure requirements for accredited investors made Rule 506 the most commonly used private offering exemption. Today, 99 percent of all private offerings under Regulation D are conducted pursuant to Rule 506. Moreover, amounts raised through unregistered securities offerings have outpaced the level of capital formation through registered securities offerings during recent years. In 2014, there were 33,429 Regulation D offerings reported on Form D filings, accounting for more than $1.3 trillion raised.[17] The JOBS Act adds securities offered pursuant to Title III and Title IV to the list of securities preempted from state regulation.

The new rules provide a nonexclusive safe harbor for an issuer to satisfy its verification requirement by obtaining tax returns to verify income, or bank or brokerage statements and a credit report to verify net worth. However, many investors are unwilling to furnish confidential tax returns and brokerage statements. Fortunately, the issuer is not required to use the safe-harbor methods of verification. In assessing whether an issuer has taken reasonable steps to verify that investors are accredited, the SEC takes a principles-based approach that does not depend on bright-line rules but relies rather on the particular facts and circumstances of each purchaser and transaction to determine whether the steps taken are "reasonable." Under this principles-based approach, the documentation, if any, that an issuer should obtain from a potential investor will depend on answers to questions such as:

- How much information about the prospective purchaser does the issuer already have? The more information the issuer has indicating that the person is an accredited investor, the fewer verification steps it may have to take to comply with the rule's requirements. For example, membership in an established angel investor group is information that may affect the likelihood of the person being an accredited investor.
- How did the issuer find the prospective investor? A person that the issuer located through publicly accessible and widely disseminated means of solicitation may need to undergo a greater level of verification scrutiny than a person who may have been prescreened as an accredited investor by a reasonably reliable third party.
- Are the terms of the offering such that only a person who is truly an accredited investor could participate? The ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors, using their own cash, could reasonably be expected to meet it is relevant in deciding what other steps are needed to verify accredited investor status.[18]

Lastly, the SEC envisioned a role for third parties that may wish to enter into the business of verifying the accredited investor status of prospective investors on behalf of issuers and allowed for such third-party verification under the principles-based approach as long as the issuer has a reasonable basis to rely on such third party.[19]

Securities sold pursuant to Rule 506 of Regulation D must contain restrictions on transferability, and the issuer must exercise reasonable care to assure that the purchasers of the securities do not intend to act as underwriters by engaging in a distribution of the securities purchased.[20] Issuers should affix a legend on the share certificates setting forth the restrictions on transferability and make reasonable inquiry to determine if the investor is acquiring the securities for himself and not for other persons.[21] The JOBS Act Title II amendments to Regulation D also implemented a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act that directed the SEC to make the Rule 506 exemption unavailable for offerings in which certain disqualified persons ("bad actors") participate, subject to a "reasonable care" exception.[22] There is no dollar limit on offerings under Rule 506 and very few other limitations.

The old Rule 506, which prohibits general solicitation but allows issuers to include up to 35 nonaccredited investors, remains available in paragraph (b) of Rule 506. Issuers relying on the old rule also need not verify that investors are accredited, as required by new Rule 507(c). Moreover, recently issued Compliance and Disclosure Interpretations by the staff of the SEC Division of Corporation Finance expand the availability of the old rule. These interpretations clarify that in appropriate circumstances communications in a closed network among members of an informal, personal network of individuals with experience investing in private offerings will not be deemed to be a general solicitation. Issuers may now conduct offerings on angel investor networks and make presentations at demo days and venture fairs without risk that such activities will be deemed to be a

Tackling the Resale Problem

By preempting state blue sky regulation of tier 2 Regulation A+ offerings, the SEC paved the way for the creation of secondary trading in Regulation A+ securities in markets recently coined "Venture Exchanges." However, further regulatory action will be required to make an active market for Regulation A+ securities a reality. To facilitate a secondary market, the SEC amended Exchange Act Rule 15c2-11 to permit an issuer's ongoing reports filed under tier 2 of Regulation A+ to satisfy a broker-dealer's obligations to review and maintain certain information about an issuer's quoted securities. However, because all offers and sales of securities, even those by shareholders, are regulated by federal and state securities laws, the secondary offer and sale by the shareholder must also comply with state blue sky laws unless such state laws are preempted. Regulation A+ preempts the primary sale of securities by the issuer. The secondary sale by the shareholder is not subject to preemption. The Fixing America's Surface Transportation Act, enacted in December 2015, provides a partial solution for secondary sales to accredited investors. It codified a resale exemption, commonly known as the "Section 4(1½)" exemption, for private resales of restricted securities to accredited investors, and it preempted state blue sky law regulation of these secondary transactions.

general solicitation.[23] On the other hand, the staff also clarified that one method of establishing the absence of a general solicitation—showing a preexisting "substantive business relationship" with prospective investors—requires that the issuer possess sufficient information to evaluate the offeree's financial circumstances and sophistication. Self-certification, without any other information about the prospective offeree, is not enough to be considered substantive.

Despite the staff's recent efforts to provide guidance on issues arising under the JOBS Act, answers to many questions require resorting to years of SEC staff interpretation and judicial precedent. For example, in response to the question, "What information can an issuer widely disseminate about itself without contravening Regulation D's prohibition on general solicitation?" the staff responded that factual business information that "does not condition the public mind or arouse public interest in a securities offering" will not violate the rule. [24] To understand the response, however, one must look to the SEC staff's long-time guidance on when such communications will be deemed an "offer"[25] and be aware that courts have interpreted the term for securities law purposes broadly beyond the common law concept of an offer.[26]

Title IV: Regulation A+

Title IV of the JOBS Act is commonly known as "Regulation A+" and has also been dubbed a "mini-IPO." Once qualified, the offering may be sold to anyone. There is no requirement that the investor be accredited or sophisticated, no restriction on the means of solicitation, and no federal restriction on transferability of the securities. Effective since June 2015, it amends the former SEC Regulation A by increasing the old offering limit of $5 million to $50 million. An offering under the new Regulation A requires an offering circular containing specific disclosures similar to those made in an IPO prospectus, and the offering is subject to SEC review and qualification of the offering circular. The offering circular must include financial statements consisting of the prior year's balance sheet and income statements for the most recent two years. The SEC review process for Regulation A+ offerings is similar to the registration process for a registered IPO. The staff of the SEC's Division of Corporation Finance reviews all Regulation A+ offering circulars and approximately 30 days from the filing date of the offering circular on Form 1-A, the staff will issue its written comments. The company responds to these staff comments by filing a series of amendments to the offering circular until all staff comments are resolved. Only then will the SEC declare the offering statement "qualified." No sales of securities may be made until the SEC declares the statement qualified. In most cases, the time period from SEC filing to the effective date is at least 60 days and in many cases much longer.

A principal benefit of Regulation A+ is its "test the waters" provisions. An issuer may solicit indications of interest before and after an offering circular is filed. While no sale commitments may be accepted until the offering circular is qualified by the SEC, there are few restrictions on the content of test-the-waters materials. Through a social media campaign, for example, companies may ask potential investors for their contact information and the dollar amount of their investment interest by asking them to reserve shares for purchase when, and if, the SEC qualifies the offering. If there is sufficient interest, upon qualification of the offering by the SEC, the issuer may then formally offer and accept subscriptions from those prospective investors who had previously expressed interest in the offering.

Regulation A+ has two tiers: tier 1, with a maximum offering limit of $20 million, and tier 2 with a maximum offering limit of $50 million. The principal difference between them is that tier 2 offerings preempt state securities laws. The SEC left intact state blue sky regulation of tier 1 offerings under Regulation A+. Another difference between the two tiers is tier 2 offerings require a financial statement audit, and the issuer must file with the SEC ongoing annual, semiannual, and current reports. Also, nonaccredited investors in a tier 2 offering may not invest more than the greater of 10 percent of their net worth or annual income in any single Regulation A+ offering. Finally, because there is no preemption of state securities laws with tier 1 offerings, audited financial statements in most cases will be necessary even though the SEC does not require financial statements to be audited in tier 1 offerings. This provision is necessary because many states require audited financial statements in order to qualify the offering in the state.

The ongoing SEC reporting required of companies conducting tier 2 Regulation A+ offerings is considered to be a "lite" form of the periodic reporting required of companies that conduct registered offerings. Unlike companies registering their securities offerings under the Securities Act on Form S-1, an issuer selling securities under the Regulation A exemption from registration does not become subject to the full regulatory regime under Section 12 of the Exchange Act, which automatically applies to issuers registering an offering under the Securities Act.[27] Companies conducting registered offerings must file periodic reports—annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K—proxy statements and beneficial ownership reports by the company's officers, directors and 10-percent shareholders.

The annual financial statement audit required of tier 2 Regulation A+ issuers need not be performed by auditors who are registered with the Public Company Accounting Board, which is a requirement for audits of SEC-registered companies. The six-month semiannual report required of Regulation A+ issuers need only contain financial state-

Solving the Facebook Problem

A privately held company automatically becomes subject to the full SEC regulatory regime under the Exchange Act once it elects to register its initial public offering under the Securities Act. A privately held company may also be required to register under the Exchange Act, if its assets and shareholder base grows to a certain size. One of the more important changes included in the JOBS Act was to increase these Exchange Act registration thresholds to mitigate what has been known as the Facebook problem, a problem confronting many startups with large numbers of stockholders. Prior to the JOBS Act, Section 12(g) of the Exchange Act required that a company with more than $10 million in total assets register any class of securities held by more than 500 shareholders of record, whether accredited or not. This Exchange Act registration triggers all of the SEC's regulations governing publicly traded companies, including, among others, periodic reporting, insider security transaction reporting, proxy statement filing, and short-swing insider trading prohibitions. The JOBS Act raised the thresholds for registration (and termination) of registration for a class of securities under the Exchange Act. As a result, an issuer that is not a bank, bank holding company, or savings and loan holding company is required to register a class of equity securities if it has more than $10 million total assets and the securities are held of record by either 2,000 or 500 persons who are not accredited investors. The JOBS Act also directed the SEC to revise the definition of "held of record" to exclude securities held by persons who received the securities under an employee compensation plan in transactions exempted from registration under the Securities Act. This last requirement addressed the Facebook problem. Prior to its IPO, Facebook, having more than $10 million in assets and more than 500 stockholders, decided to register its IPO under the Securities Act because it would have been required to register its common stock under the Exchange Act in any event.

ments that management certifies are prepared in accordance with generally accepted accounting principles in the United States. There is no requirement that the six-month financial statements in the semiannual report be reviewed by an independent auditor, as required for quarterly reports of SEC-registered companies. The ongoing reporting regime for tier 2 Regulation A+ issuers also includes a "lite" current events requirement to report certain specified events, including fundamental changes in the issuer's business, changes in control of the issuer, a departure of the principal executive officer, principal financial officer, or principal accounting officer, and any unregistered sales of 10 percent or more of outstanding equity securities.[28]

Restrictive securities laws in effect for the 90 years prior to the JOBS Act made it difficult to start and finance businesses for those who did not have access to capital sources or friends and family to provide funding. The JOBS Act enables anyone to reach out to capital sources and raise equity capital. But the "disintermediation" of Wall Street places a heavier burden on the business attorney. Without professional financial intermediaries, such as investment bankers, it will be up to business attorneys to navigate the new securities rules and regulations to ensure that they and their clients follow the right path. ■

[Editor's note: In a subsequent issue of Los Angeles Lawyer, *Part 2 of this article on the JOBS Act will discuss Title III Crowdfunding and how attorneys can counsel clients to raise capital while managing the securities law liability to their clients and themselves.]*

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1 Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§301–05, 126 Stat. 306, 315–23 (2012) (codified in scattered sections of 15 U.S.C.).

2 Equity crowdfunding involves investments in "securities," as the term is defined under the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act). *See* §2(a)(1), 15 U.S.C. §77b(1); §3(a)(10), 15 U.S.C. §78c(a)(10). A "security" includes not only stocks, bonds, limited partnership and limited liability company membership interests, but also any "investment contract" that is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party…." SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). Prior to the JOBS Act, private offering exemptions from the Securities Act's registration requirement did not allow for equity crowdfunding, which, by definition, involves a public offering to the crowd.

3 *See, e.g.*, Chance Barnett, *SEC Democratizes Equity Crowdfunding With JOBS Act Title IV*, Forbes (Mar. 25, 2015), *available at* http://www.forbes.com; *Crowdfunding: Decentralizing, Disintermediating, Disrupting*, Crowdfunder Insider (Apr. 28, 2013), *available at* http://www.crowdfundinsider.com; Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries, U.S. Sec. & Exchange Comm'n (May 7, 2012), https://www.sec.gov (last visited Oct. 26, 2016).

4 *See, e.g.*, Robert C. Pozen, *JOBS Act: Jumpstarting Business or Bilking Investors?*, Brookings Inst. (Apr. 3, 2012), *available at* https://www.brookings.edu; The JOBS Act Fails Investors and Entrepreneurs, N. Am. Sec. Admins. Ass'n (Apr. 5, 2012) http://www.nasaa.org.

5 *The Uberization of Money*, Wall St. J., Nov. 4, 2015, *available at* http://www.wsj.com.

6 15 U.S.C. §77d(a)(2).

7 SEC v. Ralston Purina Co., 345 U.S. 119 (1953); Final Rule: Nonpublic Offering Exemption, SEC Release No. 33-4552 (Nov. 6, 1962).

8 Ralston Purina, 346 U.S. 119.

9 David B.H. Martin, Jr. and L. Keith Parsons, *The Preexisting Relationship Doctrine Under Regulation D: A Rule Without Reason?*, 45 Wash. & Lee L. Rev. 1031 (1988).

10 Two surveys cited by the SEC last fall concluded that the average initial compliance cost associated with conducting an IPO is $2.5 million, followed by an ongoing compliance cost for issuers, once public, of $1.5 million per year. The SEC staff notes that these estimates should be interpreted with the caveat that most firms in the IPO Task Force surveys likely raised more than $1 million. *See* IPO Task Force, Rebuilding the IPO On-Ramp (Oct. 20, 2011), *available at* http://www.sec.gov.

11 *See* David Weild and Edward Kim, *Market structure is causing the IPO crisis—and more*, Grant Thornton (June 2010), *available at* http://www. weildco.com..

12 *See*, *generally*, Rutherford B Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, Duke L.J. 1139 (1977).

13 17 C.F.R. §230.501.

14 JOBS Act, §201(a)(1).

15 *See* 17 C.F.R. §230.501(a) (accredited investors are persons that the issuer reasonably believes come within the specified categories).

16 National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290,110 Stat. 3416 (1996).

17 Scott Baugess, et al., Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014, SEC Div. of Econ. and Risk Analysis (Oct. 2015), *available at* https://www.sec.gov.

18 Keith F. Higgins, Dir., Div. of Corp. Fin., Keynote Address at the 2014 Angel Capital Association Summit, Wash., D.C. (Mar. 28, 2014), *available at* https://www.sec.gov.

19 Final Rule: Eliminated the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. 33-9415 (July 10, 2013).

20 15 U.S.C. §77b(a)(11).

21 17 C.F.R. §230.502(d).

22 17 C.F.R. §230.506(d).

21 *See* Compliance and Disclosure Interpretations (CDIs), Securities Act Rules, §§256.23 – 256.33 (Aug. 6, 2015), *available at* https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm [hereinafter CDIs]. For information regarding policies and procedures for establishing a preexisting substantive relationship with prospective offerees over the Internet, *see* Citizen VC, Inc., SEC No-Action letter (Aug. 6, 2015), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm.

24 *See* CDIs, Question 256.24.

25 *See* 17 C.F.R. §230.169; Securities Offering Reform, SEC Release No. 33-8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)] at 44731.

26 *See, e.g.*, Diskin v. Lomasney & Co., 452 F. 2d 871 (2d. Cir. 1971).

27 *See* 15 U.S.C. §78o(d); 15 U.S.C. §78m.

28 *See* 17 C.F.R. §230.257.

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To apply for credit, please follow the instructions on the test answer sheet on page 25.

PART TWO OF TWO

by Mark Hiraide

READY CAPITAL

Opening up unprecedented investment opportunities, the JOBS Act's lack of registration also engenders potential risks

THE JUMPSTART Our Business Startups (JOBS) Act of 2012 represents a sea change in the regulation of securities offerings.[1] For the first time in U.S. history, companies may offer shares of stock to the general public without registering with the Securities and Exchange Commission (SEC). The most revolutionary aspect of the JOBS Act is Regulation CF, the new rule added to the Securities Act of 1933 that legalized equity crowdfunding. The JOBS Act's two other new forms of public securities offerings, discussed elsewhere,[2] are found in Rule 506(c) of Regulation D and in Regulation A.

Under Regulation CF, companies can sell up to $1 million-worth of shares of stock to anyone no matter the person's net worth or income subject to certain limits on individual investment amounts. There is no SEC qualification requirement for securities offered through crowdfunding. This compares with offerings under Rule 506(c), which can raise an unlimited amount of capital without obtaining SEC qualification but can only be sold to accredited investors, and offerings under Regulation A, which are available to all investors but are limited to $50 million and must be qualified by the SEC.

President Barack Obama noted the significance of Regulation CF in his remarks during the April 5, 2012, bill-signing ceremony.

> [F]or start-ups and small businesses, this bill is a potential game changer. Right now, you can only turn to a limited group of investors—including banks and wealthy individuals—to get funding....[A] lot has changed in 80 years, and it's time our laws did as well. Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.[3]

Equity crowdfunding was born of Internet-based fund-raising campaigns that gained popularity with the success of two of the largest crowdfunding websites, Kickstarter and Indiegogo. Both offered a platform for crowdsourcing funding for projects that included films and environmental programs in exchange for t-shirts, movie production credits, or other tokens of appreciation.[4] Prior to the JOBS Act, selling equity through crowdfunding—by definition a public offering—required SEC registration and blue-sky law qualification in each state in which the securities were offered. Regulation CF under Title III of the JOBS Act creates an exemption from registration specifically for equity crowdfunding and preempts state securities qualification laws.

Companies have raised just over $14 million using Regulation CF since it became effective in May 2016. In November 2016, Indiegogo announced its project backers would be able to make equity investments by using Regulation CF.[5] Indiegogo is by far the largest crowdfunding platform to enter the equity space, having raised more than $1 billion from eight million backers of nonequity projects.

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Entrepreneurs now may offer Indiegogo's 15 million monthly visitors an opportunity to invest in their company.[6] This entry by a major crowdsourcing platform may kick-start the equity crowdfunding industry.

As the public capital markets have become accessible to all, general business lawyers, and not just securities law specialists, will need to respond to client questions about taking advantage of this new pool of potential investors. Thus, they require at least a working knowledge of the new methods and rules for raising capital under Regulations D, CF, and A under Titles II, III, and IV, respectively, of the JOBS Act. In particular, lawyers must be clear about the liabilities associated with these new offering methods, as the JOBS Act did not change the statutory joint and several civil liability for persons who control the company selling securities.

Equity Crowdfunding

The SEC's rules for the new Regulation CF[7] exemption enable entrepreneurs to raise up to $1 million during any 12-month period from anyone who wants to invest, subject to certain dollar limits on the amount of the individual investment. There is no requirement that the investor be accredited or sophisticated. If the investor's net worth or income is below $100,000, the investor is subject to an investment cap of the greater of $2,000 or five percent of the lesser of the investor's annual income or net worth. For those individuals whose net worth and annual income are at least $100,000, the investment cap is 10 percent of the lesser of the investor's annual income or net worth, not to exceed an investment of $100,000.[8] These caps reflect the aggregate amount an investor may invest in all offerings under Regulation CF in a 12-month period across all companies.[9]

To qualify for the crowdfunding exemption, the company must prepare an offering statement on Form C, which must include general information about the company and its officers, directors, and significant shareholders; the intended use of proceeds; the company's ownership and capital structure; and financial statements for the two most recently completed fiscal years.[10] If the offering amount is greater than $100,000 but less than $500,000, the financial statements must be reviewed by an independent accountant. If the offering amount is greater than $500,000, the financial statements must be audited, unless the company is conducting its first Regulation CF offering, in which case the financial statements need only be reviewed. For offerings less than $100,000, the financial statements need only be certified by the company's principal officer.[11] The company must file the offering statement with the SEC on Form C, but the filing is not reviewed by the agency.[12] Once Form C is filed, the offering may commence immediately. The company is required to set forth a minimum or target offering amount, and investor proceeds must be deposited in a third-party escrow account until the minimum is reached.

A significant limitation under Regulation CF is the requirement that all offerings be conducted through a single Internet portal, which must either be registered with the SEC as a broker-dealer or as a new form of regulated entity—a funding portal. Funding portals are regulated by the self-regulatory organization, Financial Industry Regulatory Authority (FINRA). There are currently 21 funding portals registered with FINRA.[13] Unlike broker-dealers, a funding portal may not offer investment advice or recommendations, solicit investments to buy the securities offered on its website or portal, pay commissions to its employees or agents, or take custody of investor funds. Similarly, unlike persons associated with a broker-dealer, persons associated with a funding portal are not subject to any licensing, testing, or qualification requirements.

Funding portals play a limited gatekeeper function.[14] Regulation CF requires a funding portal to have a reasonable basis for believing that a company selling securities on its platform complies with Regulation CF.[15] It is up to the portal to assess whether there is reason to question the reliability of a company's representation of compliance.

As with any securities offering, rules relating to permissible communications and advertising are critical to the success of the offering. Regulation CF strictly limits communications that mention the terms of the offering published by a company and third parties compensated by the company to promote its offering.[16] Restrictions on advertising under Regulation CF raise difficult interpretive issues. How the SEC and courts resolve these questions will likely be informed by SEC staff positions articulated in future releases, no-action letters, and speeches.

Advertising Offerings

The new statutory exemption for equity crowdfunding provides that the company shall "not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker."[17] The notices may not include anything other than: 1) a statement that the company is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the investor to the intermediary's platform; 2) the terms of the offering; and 3) factual information about the legal identity and business location of the company, limited to a brief description of the company.[18] Historically, notices of this type have been referred to as tombstone advertisements, because the factual information about the company must be limited to a brief description of a few sentences. These restrictions on the content of advertising apply also to any third parties—for example, consultants and public relations firms—that the company compensates to promote the offering outside of the platform.[19]

The only other form of advertising expressly sanctioned by Regulation CF are company communications (identified as such) with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform.[20] In adopting the crowdfunding rules, the SEC recognized the wisdom of the crowd—a central tenet of crowdfunding—and provided means for the company to respond to questions about the terms of the offering.[21] To accommodate these rules, crowdfunding portals now universally include a comment section for each crowdfunding offering that allows the public and the company to post comments and responses.

The limited forms of advertising expressly authorized by Title III have been widely criticized, leading many to conclude that Title III is unworkable.[22] Thus, there are now efforts to amend the JOBS Act.[23] Advocates of reform argue that allowing companies to advertise "off portal" is essential to drive traffic to the portals where investors may view the terms of the offering and other requisite disclosures. If companies are not allowed to conduct their own campaigns to generate interest in their business and to direct prospective investors to the portal, few, if any, may know of the offering—a result surely not intended by lawmakers. Restricting off-portal communications furthermore would prevent companies from taking advantage of modern communication technology and social media to drive traffic to the portal.

In May 2016, the SEC staff issued a number of compliance and disclosure interpretations that offer some relief from the strict statutory language.[24] As to communications occurring outside the portal, the staff distinguishes between communications occurring before and after filing Form C. Prior to filing the offering statement on Form C, any activity that may constitute an offer is prohibited because Section 5 of the Securities Act prohibits offers as well as sales, unless registered or exempt from registration. The term "offer" is defined broadly in Section 2(a)(3) of the Securities Act as "every attempt or offer to dispose of, or solicitation of an offer to buy…for value." The SEC and the courts interpret the term "offer" broadly. In adopting Regulation CF, the SEC staff explained that "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing interest in the company or in its securities constitutes an offer."[25] The SEC has long cautioned that publicity prior to a proposed offering may be considered an effort to condition the market.[26]

As to communications after Form C is filed, the SEC staff interprets the statutory prohibition on advertising the terms of the offering literally, and concludes that a company is not restricted in communicating information that might occur in the ordinary course of its operation as long as the communication does not refer to the terms of the offering.[27] The SEC defines "terms of the offering" as the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period.[28] Expanding on its interpretation, the SEC staff states that if a company's advertisement does not include any of the terms of the offering, its message can extend beyond the limited information in the tombstone-type notices that include no more than the circumscribed company description. This suggests that the staff may allow companies and the third parties they hire to promote an offering to disseminate unrestricted information about the company in communications that direct prospective investors to the funding portal.[29]

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Before the JOBS Act, public offerings to unsophisticated investors required SEC registration or qualification. In registered public offerings, communications by the company and offering participants are strictly circumscribed. Violations of these restrictions generally are referred to as "gun jumping" and give rise to statutory rescission remedies to investors.

Although only effective since May 2016, Regulation CF has spawned new forms of securities solicitations heretofore never seen in the highly regulated public securities offering market. Incorporating the creativity of Madison Avenue (or its cyber equivalent), companies and their crowdfunding marketing consultants are crafting campaigns designed to appeal to unsophisticated investors. For example, two- or three-minute videos that rival Hollywood movie trailers are de rigueur. Promotional giveaways of t-shirts and other gifts, common in nonequity crowdfunding campaigns, are now featured in several crowdfunded securities offerings. For now, however, the SEC staff may monitor these new offering techniques and allow the new paradigm to unravel, at least until the next Bernard Madoff or Enron catalyst causes the regulatory pendulum to reverse course. It is likely, though, that before the regulators take action the crowd will lose money, as early-stage investments in startups are risky.

Prior to the JOBS Act, issuers engaged financial intermediaries—e.g., investment banking firms—to sell their securities to the public. The JOBS Act's disintermediation of Wall Street has left it to the companies themselves to underwrite their offerings and has spawned a cottage industry of crowdfunding consultants and finders who assist companies with selling their securities. The emergence of this new category of consultants is bringing to bear difficult securities-law issues in equity crowdfunding offerings, namely, the permissible scope of activity of consultants and finders who are not registered and licensed as broker-dealers and the compensation that issuers may pay them. The question is whether these consultants and finders are required to be registered and licensed, and, if they are not, whether issuers will be allowed to pay "transaction-based compensation," i.e., commissions or other compensation contingent on the sale of a security to consultants who assist issuers in finding and soliciting investors.

Federal securities laws and state blue-sky laws prohibit a person from "engaging in the business of effecting transactions in securities" without being first registered with the SEC as a broker-dealer and licensed with FINRA. Section 15 of the Securities Exchange Act of 1934 requires that brokers and dealers in securities register with the SEC. Each state also has its own requirements for broker/dealer registration. A "broker" is "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank."[30] A "dealer" is a "person engaged in the business of buying and selling securities for his own account, through a broker or otherwise."[31] Many unlicensed consultants and finders work for transation-based compensation by erroneously relying on an old, narrow SEC staff policy exception—the so-called "finder's exception"—to the broker-dealer licensure requirement. For many years, knowingly or not, unregistered finders relied on a series of SEC staff no-action letters, including one in particular, in which the staff in 1991 agreed that it would not take enforcement action against entertainer Paul Anka for receiving a transaction-based fee for introducing an investment opportunity to persons whom he believed to be accredited investors. The staff recognized that the transaction was a one-time occurrence for Anka and that he was not in the business of providing finder services.[32] The SEC's interpretation at that time was predicated on the absence of the following factors, all of which tend to indicate broker/dealer activity: participation in negotiations, counseling investors on the merits of investing, recommending the investment to investors, receiving compensation based on a percentage of the offering proceeds, holding securities or cash, providing details of the financing to investors, and conducting sales efforts.[33]

Unregistered Finders

Many unregistered finders, some of whom labeled themselves as "investment bankers," ignored, or were unaware of, the primary factor in the SEC's decision that the compensation was a one-time occurrence. As a result, in 2010, the SEC staff issued a no-action letter in which it declared that the receipt of transaction-based compensation alone, which the SEC staff often describes as a "salesman's stake,"[34] may be sufficient to require licensure. In the letter, SEC staff recounted how the law firm of Brumberg, Mackey & Wall, P.L.C., itself sought to receive a finder's fee for introducing its client to potential investors. The law firm represented to the SEC staff that it would not engage in any negotiations whatsoever on behalf of its client, would not provide any potential investor with information about the client that might be used as the basis for negotiations for funding, and would not have responsibility for, nor make recommendations concerning, the terms, conditions, or provisions of the financing.[35] According to the SEC staff, "[a] person's receipt of transaction-based compensation in connection with these activities is a hallmark of broker-dealer activity."[36] One federal district court has rejected the SEC staff's interpretation of the law.[37]

As with the finder's exception, unlicensed persons sometimes mistakenly rely on the "issuer exemption" from broker registration under Securities Exchange Act Rule 3a4-1. That rule provides a nonexclusive safe harbor from broker-dealer registration for an individual employee or agent of the issuer who, among other things, "is not compensated by the payment of commissions or other remuneration based either directly or indirectly on transaction in securities." Whether a particular compensation arrangement is "other remuneration" based either directly or indirectly on transactions in securities depends on the particular facts and circumstances. For example, in determining whether a particular compensation arrangement involving the payment of bonuses would not be permissible under the rule, the following factors may be relevant: 1) when the offering commences and concludes, 2) when the bonus is paid, 3) when it is determined that a bonus will be paid, 4) when associated persons are informed of the issuer's intention to pay a bonus, and 5) whether the bonus paid to particular associated persons varies with their success in selling the issuer's securities.[38]

Issuers sometimes view paying transaction-based compensation to unlicensed consultants and finders as the unlicensed person's problem. Indeed, some issuers sometimes use the person's unlicensed status as a basis to void the person's compensation arrangement.[39] However, paying an unlicensed broker to solicit investors exposes an issuer to potential significant civil liability, as there is authority for investors to seek rescission against such an issuer.[40] At the federal level, Section 29(b) of the Securities Exchange Act of 1934 provides that "[e]very contract made in violation of any provision of this title … shall be void." Many consider this language sufficiently broad to support a rescission claim against an issuer who pays transaction-based compensation to an unlicensed broker-dealer.[41] A number of appellate courts have interpreted Section 29(b) to allow rescission by investors and by issuers of transactions in securities with unregistered broker-dealers.[42] While the holdings of these cases invalidated the agreement and transaction between the investor or the issuer and the nonregistered finder, there is dicta in at least one case that the offering itself, as evidenced by the contract between the issuer and the investor, also could be invalidated by Section 29(b).[43]

In California, Section 25501.5 of the Corporations Code provides a right of rescission to investors who purchase a security from an unlicensed broker-dealer. Section 1029.8 of the Civil Code makes mandatory treble damages (up to $10,000) against a person who causes injury or damage to another person as a result of providing goods or performing services for which a license is required by specified statutes. It further provides that the court "may, in its discretion, award all costs and attorney's fees to the injured person if that person prevails in the action."[44] The California legislature amended Section 1029.8 to make specific reference to the broker-dealer and investment adviser registration provisions when it enacted Corporations Code Section 25501.5.[45]

To facilitate capital access, the California legislature enacted a new law that took effect in January 2016, which attempts to offer some relief for finders in transactions exclusively within California.[46] However, the new California law does not include any relief for solicitors who provide any more than the most basic information about the issuer and offering. The law also requires that the finder file an information statement with the California Department of Business Oversight prior to the transaction.[47] Moreover, the law does not provide relief from the SEC's strict interpretive position or from every other state's broker-dealer registration requirements.

Lawyers are not immune from federal and state broker-dealer registration requirements. Last year the SEC sued several lawyers and law firms, including one Los Angeles immigration law firm, for acting as unregistered brokers.[48] The law firms accepted commissions in connection with investments made as part of the federal EB-5 Immigrant Investor Program. An SEC press release quoted Andrew J. Ceresney, director of the SEC's Division of Enforcement: "Individuals and entities performing certain services and receiving commissions must be registered to legally operate as securities brokers if they're raising money for EB-5 projects…[t]he lawyers in these cases allegedly received commissions for selling, recommending, and facilitating EB-5 investments, and they are being held accountable for disregarding the relevant securities laws and regulations."[49]

Liabilities

The JOBS Act opened the door to nonaccredited investors who want to participate in the world of investing in unregistered securities offerings. Prior to the JOBS Act, although Regulation D and most states allowed companies to accept investments from up to 35 nonaccredited investors, securities lawyers frequently counseled clients to steer clear of this investor class. The disclosure requirements for nonaccredited investors were nearly identical to those required in a registered public offering. And the risk of a liability claim by an unsophisticated investor outweighed any benefit of receiving the relatively small investments.

Lawyers counseling clients who undertake exempt public offerings in the new paradigm under the JOBS Act must appreciate the greater exposure to liability—to their clients and to themselves. Courts and the SEC have long considered securities lawyers as occupying a unique role in advising companies selling securities to the public. Both the SEC, in its civil enforcement actions, and the U.S. Department of Justice, which prosecutes criminal securities cases,[50] have sued lawyers and routinely remind the public of attorneys' gatekeeping function. Exposure to securities laws claims is heightened in equity crowdfunding offerings in which there is typically no involvement of a professional intermediary, including an investment banking firm, which,

MCLE Test No. 265

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MCLE test 265 is based on parts 1 and 2 of the article "Ready Capital," on the JOBS Act. See *Los Angeles Lawyer* December 2016 and February 2017 respectively.

1. An individual accredited investor must have an annual income of $200,000 in each of the two most recent years (or $300,000 joint income) and have a net worth in excess of $1 million, excluding home equity.
True.
False.

2. There is no limit on the amount of securities that may be sold in an offering pursuant to Rule 506 of Regulation D.
True.
False.

3. A company may not sell securities to a nonaccredited investor pursuant to Rule 506(b) of Regulation D.
True.
False.

4. Today, 99 percent of all private offerings under Regulation D are conducted pursuant to Rule 506.
True.
False.

5. Securities offerings pursuant to Regulation A preempt state securities "blue sky" laws.
True.
False.

6. Investors in securities offerings pursuant to Regulation CF and Regulation A are not required to satisfy any sophistication test.
True.
False.

7. Companies that conduct securities offerings under Tier 1 of Regulation A are subject to ongoing reporting requirements.
True.
False.

8. Equity crowdfunding offerings under Regulation CF (Title III of the JOBS Act) must be conducted using a funding portal regulated by the Financial Industry Regulatory Authority (FINRA).
True.
False.

9. There is no requirement that an investor in an equity crowdfunding offering under Regulation CF be accredited or sophisticated.
True.
False.

10. If either an investor's annual income or net worth is $1 million or more, there is no limit on the amount that the investor may invest in all crowdfunding offerings under Regulation CF in a 12-month period.
True.
False.

11. An issuer of securities in a crowdfunding offering under Regulation CF must file with the SEC an offering disclosure statement on Form C.
True.
False.

12. A securities offering under Regulation CF may not commence until the SEC qualifies the Form C.
True.
False.

13. There are no restrictions on communications or advertising securities offerings under Regulation CF.
True.
False.

14. Before the JOBS Act, public offerings to unsophisticated investors required SEC registration or qualification.
True.
False.

15. The so-called "finder's exception" to broker-dealer licensure requirements allows an unlicensed person to receive transaction-based compensation in connection with the sale of a security, provided that the unlicensed finder does not negotiate the terms of the investment.
True.
False.

16. Under the "issuer exemption" safe harbor Rule 3a4-1 an employee who engages in the sale of the employer's securities may receive a cash performance bonus based on the amount of securities sold.
True.
False.

17. Paying an unlicensed broker to solicit investors exposes an issuer to potential significant civil liability.
True.
False.

18. The investor plaintiff bears the burden of proof to establish that the company defendant violated the requirements of the exemption from registration.
True.
False.

19. Failure to satisfy the requirements of Rule 506(c), Regulation A or Regulation CF will result in loss of the exemption from registration and give rise to liability under Section 12(a)(1) only if the investor plaintiff proves that the company defendant acted with scienter or negligently.
True.
False.

20. In California, attorneys rendering securities law advice are held to a higher standard of care in legal malpractice actions.
True.
False.

MCLE Answer Sheet #265

READY CAPITAL

Name ______________________

Law Firm/Organization ______________________

Address ______________________

City ______________________

State/Zip ______________________

E-mail ______________________

Phone ______________________

State Bar # ______________________

INSTRUCTIONS FOR OBTAINING MCLE CREDITS

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ANSWERS

Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1.	☐ True	☐ False
2.	☐ True	☐ False
3.	☐ True	☐ False
4.	☐ True	☐ False
5.	☐ True	☐ False
6.	☐ True	☐ False
7.	☐ True	☐ False
8.	☐ True	☐ False
9.	☐ True	☐ False
10.	☐ True	☐ False
11.	☐ True	☐ False
12.	☐ True	☐ False
13.	☐ True	☐ False
14.	☐ True	☐ False
15.	☐ True	☐ False
16.	☐ True	☐ False
17.	☐ True	☐ False
18.	☐ True	☐ False
19.	☐ True	☐ False
20.	☐ True	☐ False

as a registered broker-dealer, is required to conduct due diligence investigations in connection with the securities offering.[51] In most equity crowdfunding offerings, third-party due diligence is left to the lawyers and accountants, who often end up as the only deep-pocket defendants when investors sue to recover their losses.

Liability under federal and state securities laws is unlike liability under the common law. Federal and state statutory securities-law remedies offer both procedural and substantive benefits to investors unavailable to them under rights of action at common law and in equity for breach of contract, breach of warranty, and the tort remedy for common law deceit.[52] The purpose of the civil liability provisions of California's Corporate Securities Law of 1968 "is to create statutory liability that eliminates some of the elements of common law fraud, but balances this expansion of liability by placing other restrictions on recovery."[53] The statutory securities rescission remedies sometimes may be described as providing for strict liability because unless the defendant company is able to sustain affirmative burdens of proof, it will be liable. More important, in the wake of the 1929 stock market crash and Great Depression, Congress and the states imposed joint and several rescission liability on the individuals who control the company that violates the securities laws, unless the control person is able to sustain the burden of a due diligence affirmative defense.[54]

Two Bases

Section 12(a) of the Securities Act provides investors with two bases to assert a right of rescission.[55] Under Section 12(a)(1) investors have a right of rescission against any person who offers or sells a security in violation of the registration requirement. Thus, failure to satisfy the requirements of rule 506(c), Regulation A or Regulation CF will result in loss of the exemption from registration and give rise to liability under Section 12(a)(1). It imposes almost absolute liability when the seller is unable to prove that it satisfied the requirements of the exemption. The plaintiff is not required to prove scienter or even negligence by a company defendant that fails to establish the requirements of the applicable exemption.

The second basis for rescission is pursuant to Section 12(a)(2), which provides investors a right of rescission against sellers who offer or sell securities by means of a prospectus or oral communication that contains misstatements and omissions of material information. However, unlike Section 12(a)(1), Section 12(a)(2) provides a due diligence affirmative defense that the seller "did not know, and in exercise of reasonable care could not have known, of such untruth or omission."[56] Hence, counsel must assist management in memorializing its reasonable basis for the statements made in its offering document. Section 12(a)(2) claims also are subject to a "loss causation" affirmative defense that the investor's loss was not caused by the false or misleading statement or material omission.

In California, Corporations Code Sections 25501 and 25503 provide a remedy similar to the federal remedies under Securities Act Sections 12(a)(1) and 12(a)(2). Similarly, California provides for joint and several liability of individuals who control the company. California's joint and several control person liability provision, Corporations Code Section 25504, is especially broad, providing that

> [e]very person who directly or indirectly controls a [company] liable under Section 25501 or 25503, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a company so liable who materially aids in the act or transaction constituting the violation, are also liable jointly and severally liable with and to the same extent as such [company], unless the other person who is so liable had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist.

A California court of appeal decision in 2011 makes it difficult to demur to lawsuits seeking joint and several rescission liability against officers and directors. In *Hellum v. Breyer*, the investor plaintiffs sought to hold the individual directors of a defendant company jointly and severally liable for the rescission liability of the company, based solely on the outside directors' status as directors.[57] The outside directors, each of whom was affiliated with one of the company's venture capital fund investors, demurred to the complaint on the grounds that it failed to allege any facts showing the outside directors' involvement in or knowledge of the offending securities offering. The trial court granted the outside directors' demurrer. The court of appeal reversed the trial court ruling, stating, "We believe the plain language of §25504 means that principal executive officers and directors are presumptively liable for their corporation's issuance of unqualified securities, regardless of whether they participated in the transactions at issue, or controlled the company."[58] The court rejected outright the outside directors' claim that the "weight of authority" supported their argument that the plaintiffs had to plead facts to show that the outside directors controlled the company.[59]

Lawyers counseling clients who undertake exempt offerings in reliance on Rule 506(c) of Regulation D, Regulation A, or Regulation CF must appreciate the greater exposure to liability in offerings made to the public. In California, attorneys rendering securities advice are held to a higher standard of care in legal malpractice actions.[60] Representing a company conducting an exempt offering subjects the lawyer to the SEC rules governing standards of professional conduct of lawyers.[61] Equity crowdfunding offerings present unique challenges for lawyers who engage in general business practices as well as securities law. The absence of professional intermediaries in crowdfunded offerings, in addition to sometimes leaving lawyers and accountants as the only deep-pocket defendants, assigns due diligence responsibilities to the company and its counsel. Establishing evidence of the requisite due diligence is paramount to protecting the company and its control persons because if the affirmative burden of the due diligence defense when it is available is not sustained, liability to investors is nearly absolute.

In determining if attorneys have performed adequate due diligence, California practitioners should be aware of the Ninth Circuit decision in *FDIC v. O'Melveny & Myers,* in which the Federal Deposit Insurance Corporation (FDIC), as receiver for failed savings and loan association American Diversified Savings Bank (ADSB), filed a lawsuit in the Central District of California against O'Melveny & Myers claiming professional negligence in connection with its legal advice in counseling ADSB in private securities offerings.[62] O'Melveny prepared two private placement memoranda and wrote substantial portions of the memoranda, edited other portions, and performed a due diligence review. It was undisputed that the memoranda contained false information about the company's financial condition. The FDIC commenced its suit against O'Melveny, charging the firm with professional negligence, negligent misrepresentation, and breach of fiduciary duty. In reversing the trial court's summary judgment in favor of O'Melveny, the Ninth Circuit stated:

> Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a "reasonable, independent investigation to detect and correct false or misleading materials." (Citations omitted.) This is what is meant by a due diligence investigation.[63]

The O'Melveny decision has been cited for the proposition that the duty of care

owed by an attorney to a client includes reasonably protecting the client from liability that might flow based on its agent's dissemination of false or misleading statements to the public.[64]

Under the restrictive securities laws in effect for the 90 years prior to the JOBS Act, entrepreneurs who did not have access to friends and family who could provide seed capital had little chance of getting their startups off the ground. Today, seed funding at the attainable $250,000 to $750,000 level—not the millions of the past—could, with modern technology, be just enough to advance an entrepreneur's ideas, develop a prototype, enter into a first contract, or otherwise validate a vision or business model in order to get on the radar of institutional investors and rise to the next level of success. Without such early funding, those entrepreneurial businesses would be lost in a sea of concepts floating over the transom to the inboxes of managers at venture capital funds. Thus, in theory, Regulation CF enables anyone to reach out to capital sources and raise seed levels of money. No doubt, without the benefit of professional financial intermediaries, such as investment bankers, entrepreneurs on their own will face challenges raising capital. What the JOBS Act offers, however, is a pathway for companies eventually to reach these public equity markets, which prior to the JOBS Act, were accessible to only the most privileged few. It will be up to business lawyers to navigate the new securities rules and regulations to ensure that their clients do not get lost along the way. "Fasten your seat belts, it's going to be a bumpy night."[65] ■

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[1] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§301–05, 126 Stat. 306, 315–23 (2012) (codified in scattered sections of 15 U.S.C.).

[2] For the full discussion of Rule 506 (c) of Regulation D and Regulation A of the JOBS Act, *see* Mark Hiraide, *Ready Capital*, L.A. LAWYER (Dec. 2016), *available at* https://www.lacba.org/news-and-publications/los-angeles-lawyer.

[3] Press Release, The White House, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), *available at* https://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing.

[4] Rob Walker, *The Trivialities and Transcendence of Kickstarter*, N.Y. TIMES MAGAZINE (Aug. 5, 2011), *available at* http://www.nytimes.com.

[5] Stacy Cowley, *Ever Wanted to Back a Start-Up? Indiegogo Opens the Door to Small Investors*, N.Y. TIMES (Nov. 15, 2016), *available at* http://www.nytimes.com.

[6] Anthony Volastro, *Indiegogo jumps into fledging equity crowdfunding space*, CNBC (Nov. 16, 2016), *available at* http://www.cnbc.com/2016/11/16/crowdfunding-giant-indiegogo-gets-into-start-up-equity-funding.html.

[7] 17 C.F.R. §§227 *et seq.*; 15 U.S.C. §77d(a)(6).

[8] 17 C.F.R. §227.100.

[9] Securities issued in offerings under Regulation CF are exempt from the registration requirement of Section

12(g) of the Securities Exchange Act of 1934, which subjects registrants to the full regulatory regime for SEC-registered publicly traded companies, until the company exceeds $25 million in total assets, after which time it is granted a two-year transition period before it is required to register its class of securities. 17 C.F.R. §240.12g-6.

[10] 17 C.F.R. §227.201.

[11] 17 C.F.R. §201(t).

[12] 17 C.F.R. §203.

[13] Funding Portals We Regulate, FINRA, *available at* http://www.finra.org (last visited 12/20/16).

[14] SEC Chairperson Mary Jo White, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016). *available at* https://www.sec.gov (last visited Dec. 21, 2016).

[15] 17 C.F.R. §301(a).

[16] 17 C.F.R. §204.

[17] 15 U.S.C. §77d-1(b)(2).

[18] 17 C.F.R. §227.204.

[19] 17 C.F.R. §227.205(b).

[20] 17 C.F.R. §227.204(c).

[21] SEC Release No. 33-9974 (Oct. 30, 2015), Crowdfunding.

[22] Robb Mandelbaum, *Will S.E.C. Advertising Rules Cripple Equity Crowdfunding?*, FORBES (May 31, 2016), *available at* http://www.forbes.com.

[23] *The JOBS Act at Four: Examining Its Impact and Proposals to Further Enhance Capital Formation*: Hearing Before the H. Subcomm. on Capital Markets and Government Sponsored Enterprises, 114th Cong. (Apr. 11, 2016), *available at* http://financialservices.house.gov (last visited Dec. 21, 2016).

[24] Regulation Crowdfunding Compliance and Disclosure Interpretations, *available at* https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm [hereinafter Regulation Crowdfunding CDI].

[25] SEC Release 33-9974, n.553.

[26] *See* SEC Release no. 33-3844 (Oct. 8, 1957).

[27] *See* Regulation Crowdfunding CDI, Question 204.03 (May 13, 2016), available at https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm.

[28] See Instruction to Rule 204.

[29] Sara Hanks, Communications and publicity by issuers prior to and during a Regulation CF offering, Crowdcheck (June 2016), *available at* http://www.crowdcheck.com. Cochair of the SEC's Advisory Committee on Small and Emerging Companies, Sara Hanks authored a widely circulated memorandum on advertising rules under Regulation CF.

[30] 15 U.S. Code §78c(a)(4).

[31] 15 U.S.C. §78c(a)(5).

[32] Paul Anka, SEC no-action letter (July 24, 1991).

[33] *See, e.g.*, Richard S. Appel, SEC no-action letter (Jan. 13, 1983); John DiMeno, SEC no-action letter, (Oct. 11, 1978).

[34] *See, e.g.*, Herbruck, Alder & Co., SEC no-action letter (June 4, 2002), *available at* https://www.sec.gov.

[35] No-action request letter from Brumberg, Mackey & Wall, P.L.C., (May 17, 2010), *available at* https://www.sec.gov.

[36] *Id.*

[37] SEC v. Kramer, 778 F. Supp. 2nd 1320 (M.D. Fla. 2011).

[38] Persons Deemed Not To Be Brokers, Exchange Act Release No. 22,172 [File No. S7-19-84] (June 27,1985).

[39] *See* Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 999 (May 2005).

[40] *Id.*

[41] *Id.*

[42] *See, e.g.*, Regional Props., Inc. v. Financial & Real Estate Consulting Co., 678 F. 2d 552, 558 (5th Cir. 1982); Eastside Church of Christ v. National Plan. Inc., 391 F. 2d 357 (5th Cir.), *cert. denied sub nom.* Church of Christ v. National Plan, Inc., 393 U.S. 913 (1968). *See generally* Samuel H. Gruenbaum & Marc I. Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 GEO. WASH. L. REV. 1 (1979).

[43] Regional Props., 678 F. 2d at 561; *see also* Western Fed. Corp. v. Erickson, 739 F. 2d 1439, 1443-44 n.5 (9th Cir. 1984).

[44] CIV. CODE §1029.8.

[45] A.B. 2167 (Correa) (Sept. 18, 2004).

[46] CORP. CODE §25206.1.

[47] CORP. CODE §25206.1(a)(8).

[48] SEC v. Hui Feng and Law Offs. of Feng & Assocs. P.C., No. 09420-CBM-SS (U.S.D.C. Central Dist. Dec. 7, 2015), *Complaint available at* https://www.sec.gov/litigation/complaints/2015/comp-pr2015-274.pdf.

[49] Press Release, SEC: Lawyers Offered EB-5 Investments as Unregistered Brokers, *available at* https://www.sec.gov.

[50] *See, e.g.*, Press Release, SEC, SEC Charges New Orleans-Based Energy Company and Executives With Fraudulent Stock Manipulation: Houston-Based Attorney Charged With Facilitating Scheme in Gatekeeper Role, (Dec. 15, 2014), *available at* https://www.sec.gov; Press Release, U.S. Att'y's Off., Securities Attorney Arrested in Boston-Based Market Manipulation Scheme (Nov. 6, 2014), *available at* https://www.fbi.gov.

[51] FINRA Regulatory Notice 10-22, Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings (Apr. 2010), *available at* https://www.finra.org.

[52] Arei II Cases, 216 Cal. App. 4th 1004 (2013).

[53] CORP. CODE §§25000 *et seq.*

[54] 15 U.S.C. §77o; 15 U.S.C. §78t(a).

[55] The JOBS Act expressly made applicable Section 12(b) to Title III and Title IV offerings. *See* discussion of Gustafson v. Alloyd Co., Inc., 513 U.S. 561 (1995) (holding that the Section 12(a)(2) antifraud provision does not apply to private offerings).

[56] 15 U.S.C. §77l(a).

[57] Hellum v. Breyer, 194 Cal. App. 4th 1300 (2011).

[58] *Id.* at 1308.

[59] The court noted that the California legislature used markedly different language from that of the federal controlling liability statutes. *See Id.* at 1312 n.5.

[60] PAUL W. VAPNEK, ET AL., CAL. PRACTICE GUIDE: PROF'L RESPONSIBILITY ¶ 6:231 (2015). S*ee also* Wright v. Williams, 47 Cal. App. 3d 802, 810 *and* Federal Deposit Ins. Corp. v. O'Melveny & Myers, 969 F. 2d 744, 748 (9th Cir. 1992), *reversed on other grounds* 512 U.S. 79 (1994) and opinion adopted in part, 613 F. 3d 17 (9th Cir. 1995).

[61] *See* 17 C.F.R. §§205 *et seq.* Under SEC rule 205.2(a), an attorney is deemed to be an appearing attorney not only by representing a client in an SEC proceeding but also by: 1) providing federal securities law advice concerning any document the attorney has notice will be submitted to the SEC or 2) advising a client regarding whether information must be submitted to, or filed with, the SEC. *See* State Bar of California, Legal Opinions in Business Transaction (Excluding the Remedies Opinion) (May 2005, *rev'd* 2007), *available at* http://businesslaw.calbar.ca.gov (last visited Dec. 22, 2016).

[62] O'Melveny & Myers, 969 F. 2d 744.

[63] *Id.* at 748.

[64] *Cf.* Robert J. Haft, et al., Due Diligence—Periodic Reports and Securities Offerings §4.6 (2015).

[65] Statement made by the Margo Channing character as portrayed by Bette Davis in the film *All About Eve* (1950).