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JOBS Act Creates Two New Exemptions from Broker-Dealer Registration

Introduction and Overview

On March 27, 2012, the US House of Representatives approved the final version of the Jumpstart Our Business Startups Act (called the “JOBS Act” or the “Act”)¹, which significantly liberalizes the regulatory regime relating to certain private placements and the IPO process for newly defined “emerging growth companies.” One lesser-reported aspect of the JOBS Act is that it creates two new exemptions from broker-dealer registration under section 15(a) of the Securities Exchange Act of 1934 (the “Exchange Act”): an exemption for intermediaries participating solely in offerings conducted in compliance with Rule 506 under Regulation D, and another for “Funding Portals” (commonly known as crowdfunding platforms).

Broker-dealer registration is generally required for any person who, through the use of interstate commerce (a term generally including, for example, the telephone, the internet, or e-mail), is in the business of effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security. Such registration brings with it a comprehensive and often costly regime of compliance in every aspect of the business of the broker-dealer, and therefore exemptions – which have historically been few – have been viewed as especially valuable.² The purpose of this note is to highlight and identify the requirements that must be met in order for a person to take advantage of these two new exemptions.

¹ For more information about the JOBS Act, you may wish to refer to “*JOBS Act Will Ease Rules for IPOs and Private Placements and Reduce Compliance Burdens Post IPO*”, currently available at, <http://www.shearman.com/jobs-act-will-ease-rules-for-ipos-and-private-placements-and-reduce-compliance-burdens-post-ipo-03-2012> and “*New Law Reduces Executive Compensation Disclosure Obligations and Eliminates Say-on-Pay Votes for Emerging Growth Companies*”, currently available at, <http://www.shearman.com/new-law-reduces-executive-compensation-disclosure-obligations-and-eliminates-say-on-pay-votes-for-emerging-growth-companies-04-02-2012>. For an annotated reference guide to the JOBS Act, you may wish to refer to “*The JOBS Act: Changes to Existing Law / A Blackline and Annotated Reference Guide*”, currently available at, <http://www.shearman.com/the-jobs-act-changes-to-existing-law--a-blackline-and-annotated-reference-guide-03-2012>.

² One common exemption from broker-dealer registration for non-US issuers conducting certain institutional business in the US is Rule 15a-6; for a description of Rule 15a-6 you may wish to refer to “*SEC Proposes Amendments to the Exemptions Available to Certain Non-US Broker-Dealers under Rule 15a-6*”, currently available at, http://www.shearman.com/am_070908.

Exemption for Rule 506 Intermediaries

Under Section 201(c) of the Act, intermediaries participating solely in Rule 506 offerings are exempt from broker-dealer registration provided that certain conditions are met. Accordingly, a Rule 506 intermediary is not subject to broker-dealer registration solely because that person:

- maintains a platform or mechanism that permits the offer, sale, purchase, negotiation, general solicitation, advertisements, or similar activities in connection with the offering;
- co-invests in securities being offered; or
- provides ancillary services in connection with the offering.³

In order to meet this exemption, the intermediary must:

- receive no compensation in connection with the purchase or sale of securities in the offering;
- not be in possession of customer funds or securities in connection with the offering; and
- not be subject to a statutory disqualification under section 3(a)(39) of the Securities Act of 1933 (the “Securities Act”).

This exemption appears to be designed to include certain unregistered entities that facilitate private placements under Rule 506 in accordance with the above-mentioned criteria. Other unregistered portals that narrowly fail to meet these criteria may now consider whether to adjust in order to meet the exemption, or whether their activities are such that the broker-dealer registration is not required.

The Rule 506 intermediary exemption appears to be in addition to, and possibly in some ways less onerous than, the exemption for “Funding Portals” that intermediate “crowdfunded” offerings discussed below.

In addition, it is worth noting that under the Act, state broker-dealer registration laws and rules are not pre-empted with respect to Rule 506 intermediaries.

Exemption for Crowdfunding Platforms (“Funding Portals”)

Under Section 304 of the Act, a new exemption from the broker-dealer registration is created for Funding Portals. The term “Funding Portal” is defined in new section 3(a)(80) of the Exchange Act to mean any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to new section 4(a)(6) of the Securities Act that do not

- offer investment advice or recommendations;
- solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;

³ The Act text states that no person shall be subject to registration as a broker or dealer solely because they engage in the conduct described at items (i) through (iii), suggesting that other conduct of the person, including other conduct related to the sale of securities in accordance with Rule 506, may still require broker-dealer registration.

- compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- hold, manage, possess, or otherwise handle investor funds or securities; or
- engage in such other activities as the SEC, by rule, determines appropriate.

Under the applicable amendments to the Exchange Act, a Funding Portal will be required to:

- register as a Funding Portal with the SEC;
- obtain membership in a national securities association (at present, FINRA is the only such designated entity);
- ensure that all investors positively affirm their understanding of the possibility of losing their entire investment and that they can bear such a loss, and can demonstrate their understanding of risk and illiquidity associated with the investment;
- obtain a background and securities regulatory enforcement check for the directors, officers, and holders of more than 20% of the outstanding equity of the issuer; and
- meet any other requirements that the SEC, or FINRA as the regulator of Funding Portals, prescribes as appropriate.

We note that the requirement that a Funding Portal obtain membership with FINRA will expand the unusual, but not unprecedented, category of entities that are not SEC-registered broker-dealers but that are FINRA members. This category is an awkward one, since FINRA rules are often written with SEC-registered broker-dealers in mind, and many FINRA rules assume compliance with related SEC regulations. In this regard, Section 304 of the Act explicitly provides that a national securities association shall only examine for, and enforce against, a registered Funding Portal rules that are written specifically for registered Funding Portals. Thus, prior to fully exercising its newly acquired jurisdiction over Funding Portals, FINRA will be required to create new rules designed and tailored to regulate this new class of member which is not registered with the SEC as a broker-dealer.

The Act provides that state securities or “Blue Sky” laws are pre-empted with regards to registered Funding Portals; however, pre-emption does not extend to the laws of the state in which the principal place of business of the registered Funding Portal is located. Any applicable Blue Sky law must not be in addition to, or be different from, the requirements for registered Funding Portals established by the SEC.

Conclusion

The JOBS Act is expected to be signed into law shortly. The SEC is obligated to adopt several regulations to effectuate certain provisions of the JOBS Act and it will be particularly interesting to see how FINRA adjusts to regulating Funding Portals, and how these two exemptions from broker-dealer registration are applied (or used) in practice.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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