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THE JUMPSTART OUR BUSINESS STARTUPS (JOBS) ACT: AN OVERVIEW OF THE ACT AND ITS POTENTIAL IMPACT ON THE PROFESSIONAL LIABILITY INSURANCE INDUSTRY

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The Jump Start Our Business Start-Ups ("JOBS") Act was signed into law by President Obama on April 5, 2012, after being passed by an overwhelming majority of both houses of Congress. The Act consists of measures (broken up into seven titles) intended to open up access to capital and investments for entrepreneurs, relatively small companies and start-ups, with the ultimate goal of increasing job creation in the U.S.

In the approximately two years since the JOBS Act's passage, legislators and commentators have deliberated on its potential impact on the U.S. economy as a whole, as well as on individual investors and discrete industries, including the fields of securities law and professional liability insurance. Many people have high hopes for the Act as a breakthrough that will afford small business owners a better chance of success and allow more ordinary Americans to invest directly in small companies and, ultimately, foster innovation and growth. As President Obama put it in his Rose Garden speech about the Act on April 5, 2012:

> [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. . . . 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.

On the other hand, many experts and commentators fear the JOBS Act will create new opportunities for fraud on unsophisticated investors and weaken measures enacted to protect investors in recent years, such as the Sarbanes-Oxley ("SOX") Act of 2002. Former Securities and Exchange Commission Chairman Mary Schapiro noted her concerns about the Act's potential erosion of investor protections in a letter she wrote to the U.S. Senate Committee on Banking, Housing, and Urban Affairs in March 2012, before the Act's implementation. She wrote, "While I recognize that H.R. 3606 is the product of a bipartisan effort designed to facilitate capital formation and includes certain promising approaches, I believe that there are provisions that should be added or modified to improve investor protections." In a different forum and a different tone, former New York Attorney General and governor, Eliot Spitzer, wrote in a March 2012 article for *Slate* that the JOBS Act "should in fact be called the "Return Fraud to Wall Street in One Easy Step Act."

While there are arguably good reasons for the hopes and fears on both sides of the debate, the JOBS Act has not yet been fully implemented, and its full impact on investors, business owners and job creation therefore remains to be seen. This article will focus on what we know about the Act's effects to date, as well as potential claims that could arise under the Act and potentially impact professional liability insurers. The article will also provide a general overview of the Act's provisions, organized by title.

The JOBS Act: An Overview

The JOBS Act applies to a new category of companies known as "emerging growth" companies ("EGCs") (*i.e.*, companies with annual gross revenues of up to $1 billion), and puts measures into place intended to

Continued on page 17

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THE JUMPSTART OUR…

Continued from page 7

decrease costs to EGCs associated with going public, registering securities with the Securities and Exchange Commission ("SEC" or "Commission"), and making required disclosures to investors.

In summary:

- The Act permits EGCs to conduct initial public offerings (IPOs) while exempting them for up to five years from certain otherwise-applicable financial reporting and governance requirements. (The eased restrictions for IPOs are often referred to as the "IPO on-ramp" provisions, and are set forth in Title I of the Act.)
- It also relaxes restrictions on advertising and solicitation for private offerings, in Title II of the Act.
- The Act provides for statutory crowdfunding (in Title III), which will allow an EGC to raise up to $1 million annually by soliciting relatively small equity investments from a large number of investors without having to register the shares with the SEC.
- It increases from $5 million to $50 million the amount of capital that can be raised in a public offering without triggering full registration and periodic reporting obligations or mandatory compliance with state blue-sky laws (Title IV).
- Title V of the Act raises the maximum number of shareholders that trigger registration requirements for non-banks or bank holding companies from 500 to 2,000, as long as fewer than 500 are not "accredited investors" (as defined by the SEC).
- Finally, Title VI of the Act raises the maximum number of shareholders that trigger registration requirements for banks and bank holding companies from 500 to 2,000, and permits banks and bank holding companies to de-register a security if the number of record holders for it falls below 1,200 persons (as opposed to the former threshold of 300).[3]

Certain of the JOBS Act's provisions have been in force since its April 2012 enactment: namely, the IPO on-ramp provisions set forth in Title I and the increased maximum number of shareholders that trigger registration requirements under Titles V and VI. Other provisions have been in effect since September 2013 (*i.e.*, the eased restrictions on advertising and solicitation for private offerings set forth in Title II). Still others are not yet in effect (the crowdfunding provisions of Title III and the Title IV provisions increasing amount of capital that can be raised without triggering certain registration and reporting obligations), and are still in the SEC rulemaking process.

The Impact of the JOBS Act So Far

Since the enactment of the JOBS Act, the number of IPOs in the U.S. has steadily increased, reversing a trend of decreasing IPOs that had begun in 2000. In 2013, 222 IPOs were priced, compared to 125 IPOs in 2011, and 128 in 2012. In the first two quarters of 2014 alone, 134 IPOs were conducted – more than in any first-two quarter periods in the U.S. since 1999.[4] Studies also show that, unsurprisingly, virtually all companies that qualify as EGCs and have conducted an IPO since the Act's implementation have taken advantage of one or more of the Act's IPO on-ramp provisions.

On the other hand, a recent poll by the data and research firm Prequin indicates that some private equity firms have been hesitant to date to take advantage of the Act's general solicitation provisions. The firms polled cited high costs and negative perceptions associated with general solicitations, as well as concerns about conflicts with foreign securities laws, including the Alternative Investment Fund Managers Directive ("AIFMD"), a legislative initiative by the European Commission that governs hedge funds and private equity funds marketed in the European Economic Area (the EU, Iceland, Liechtenstein and Norway) and sets forth strict requirements for marketing to investors.[5] Time will tell if these concerns will ultimately curb general solicitations under the Act.

The Act's Provisions

Taken one by one, the main titles of the JOBS Act are as follows:

3 Title VII of the Act, which requires the SEC to conduct outreach and provide information about the JOBS Act to small and medium-sized businesses and businesses owned by women, veterans and minorities, is not discussed in this article.

4 Source: Renaissance Capital

5 Source: Prequin, *Private Equity Spotlight* - Volume 10 - Issue 5, May 2014

Title I (Effective April 5, 2012) – the IPO On-Ramp:

As noted above, Title I is already in effect, and provides for an easier IPO "on ramp" for EGCs within the first five years after the IPO, by scaling-down disclosure requirements, exempting EGCs from certain provisions of SOX and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and easing certain restrictions on research and issuer communications with accredited investors. First, Title I requires that an issuer provide only two years of audited financial statements – rather than the three years traditionally required– in its registration statement. It also exempts EGCs from requirements under Section 404(b) of SOX that an issuer provide an auditor attestation report on internal controls with its registration statement. It further exempts EGCs from the requirements in Section 951 of the Dodd-Frank Act that an issuer hold shareholder advisory votes on executive compensation and on golden parachutes ("Say on Pay" and "Say on Parachute" votes), and the requirement under Section 953 of the Dodd-Frank Act that issuers disclose executives' compensation to investors. EGCs may also opt to be exempt under Title I from compliance with any new or revised financial accounting standards adopted or revised on or after April 5, 2012, until non-public companies are required to comply with such standards.[6]

Also under Title I, EGCs whose common equity securities have not been previously sold pursuant to an effective registration statement under the Securities Act of 1933 may confidentially submit a draft registration statement to the SEC for nonpublic initial review, as long as the registration statement is filed publicly at least 21 days before the start of the road show. This provision allows an EGC to shield its registration statement from public scrutiny while it determines whether to proceed with the IPO, and allows for any issues or problems with the statement to be initially worked out with the SEC before the registration becomes public.

Title I also permits an EGC to gauge investor interest ("test the waters") before filing a registration statement by communicating with institutional accredited investors about the IPO prior to filing the registration statement. Finally, Title I allows analysts to publish research reports about an EGC, even if their employers are participating in an offering of the EGC's securities, although the relationship must be disclosed.

With respect to potential claims arising from Title I of the JOBS Act, it is possible that the eased reporting requirements, such as the exemption from auditor attestation reports on internal controls required under SOX, will lead to shareholder suits and regulatory investigations arising from allegedly weak internal controls, potentially exposing D&O insurers. The provision allowing issuers to "test the waters" with institutional accredited investors could also lead to suits alleging misrepresentations.

Further, the rule permitting analysts to publish research reports about an EGC even if their employers are participating in an offering of the EGC's securities could lead to charges of conflicts of interest created by the analyst's motivation to garner business for his/her investment bank employer by issuing favorable research – similar to the claims that gave rise to multiple regulatory enforcement actions against brokerage firms during the "dot-com" boom and subsequent bust in the late 1990s and early 2000s, and the $1.4 billion "Global Analyst Research Settlement" in 2003, which involved 10 investment banking firms that together paid approximately $1.435 billion to regulators and investors who had been harmed.[7]

Title II – Advertising and Solicitation for Private Securities Offerings (Effective September 2013)

JOBS Act Title II took effect on September 23, 2013, and relaxes restrictions on advertising and solicitation for private securities offerings. As a general rule, entities seeking to raise capital in U.S. markets through the issuance of securities must register those securities with the SEC unless they qualify for an exemption. However, many exemptions from registration include a prohibition on advertising – the exempted entity may not seek to broadcast the offering through media sources, whether traditional print advertising or internet based advertising.

The JOBS Act Title II directed the Commission to amend the most commonly relied upon registration exemption, Rule 506 of Regulation D of the Securities Act of 1933, "Exemption for Limited Offers and Sales

6 An EGC may elect to "opt in" and be subject to such accounting standards at the time they become applicable to public companies. An ECC's election to opt in must be made on an all-or-nothing basis, and may not be revoked later.

7 In April 2003, ten investment banking firms settled charges by the SEC, the National Association of Securities Dealers (now the Financial Industry Regulatory Authority (FINRA)), the New York Stock Exchange and the New York State Attorney General that research analysts at the firms had a practice of recommending that investors buy or hold the stocks of companies that were the firms' investment banking clients in order to generate business, even where the analysts doubted that the stocks were good investments. That settlement is often referred to as the Global Analyst Research Settlement.

Without Regard to Dollar Amount of Offering," to allow for "general solicitation" in connection with Rule 506 offerings. Accordingly, the SEC implemented Rule 506(c), which permits EGCs to conduct offerings to an unlimited number of "accredited investors"[8] and up to 35 non-accredited investors. The JOBS Act directs the Commission to remove the general restriction on solicitation to make it easier for start-ups to locate potential investors and raise necessary capital.

In July 2013, the amended rule was adopted by the SEC as Rule 506(c). Rule 506(c), which became effective on September 23, 2013, now allows issuers to advertise non-registered offerings. The new rule requires, however, that those issuers taking advantage of the solicitation provision take steps to verify that the targeted investors and ultimate purchasers are accredited under one or more SEC rules. New Rule 506 provides that reasonable steps for verifying investor accreditation could include review of IRS tax filings and/ or a written confirmation from a broker dealer or licensed attorney.

With respect Title II and amended Rule 506's implications for professional liability coverage, it is still too early to fully gauge the potential for claims arising out of "general solicitation" for unregistered offerings. Indeed, one survey of private equity managers in 2013 found that only 5% of the 150 respondents had conducted general solicitations under the new rule.

However, it is not difficult to conceive of the types of claims that could arise, for instance, in a Rule 506(c) offering where a participating investor was not accredited, but was nevertheless allowed to participate and ultimately incurred a financial loss, potentially triggering claims of rescission by all participating investors. In addition, lawyers, investment advisers and accountants could face liability for failure to "take reasonable steps" to verify accredited investor status, potentially exposing E&O policies.

Title III – Crowdfunding (Not Yet Effective)

Crowdfunding is the moniker given to the raising of capital through non-traditional means in order to fund entrepreneurial endeavors. Arguably, the most famous crowdfunding related company is Kickstarter, which operates an online platform for individuals seeking to raise funding for projects of all species, from small businesses such as bars and restaurants, to the all-time largest reported crowdfunding startup, the over $17 million raised by Cloud Imperium Games to develop the videogame "Star Citizen." To date, crowdfunding has not involved the issuance of securities, which, absent exemption, would trigger registration obligations under the federal securities laws.

Title III of the JOBS Act creates a regulatory structure to assist smaller entities in using crowdfunding to raise capital – and help drive the engines of small business – without running afoul of the federal securities laws. Under Title III, the SEC is to write rules to essentially allow crowdfunded securities issues, subject to certain capital ceilings and other limitations, without having to register the transactions with the Commission. The SEC has written proposed rules, which are currently posted for public comment.

Under the proposed rules currently posted for public comment, companies would be limited to raising an aggregate of $1 million in a 12 month period. Investors in crowdfunded enterprises would be able to contribute up to $2,000 or 5% of their annual income or net worth, if both their annual income and net worth are less than $100,000. For investors whose income is greater than $100,000, investors would be able to contribute up to 10% of their annual income, up to a maximum aggregate investment of $100,000. Some entities, including foreign companies and companies that are currently SEC-registered and reporting, would not be eligible for the proposed crowdfunding registration exemption.

Under the proposed rules, companies raising capital through crowdfunding would not be entirely beyond the Commission's oversight, however, as they will be subject to certain reporting requirements. Mandated disclosures, if the rules are adopted, would include information about directors and officers and control persons (persons owning 20% or more of the company seeking crowdfunding), descriptions of the company's business model, certain related party transactions, and financial statements that would be included with the company's tax returns.

One interesting component of Title III is that it requires that crowdfunding platforms – *e.g.*, Kickstarter – be SEC registered. That is, such entities would be required to be either a broker-dealer or an SEC-registered funding portal. These intermediaries would be required to offer certain investor-protections, including providing information about crowdfunding offerings and taking measures to prevent or reduce fraud. Intermediary

8 Investors meeting certain income or net worth requirements established by the SEC. Under Rule 501, accredited investors include individuals with net worth in excess of $1 million or have annual income in excess of $200,000.

funding portals would be prohibited, however, from providing investment advice or making recommendations with respect to individual crowdfunding issues.

Because the SEC's proposed rules have not yet take effect, it is difficult to ascertain the potential for crowdfunding-related D&O and E&O claims. Given the nature of such funding, however, *i.e.*, that it would be limited to small businesses raising limited amounts of capital, the principal risk will likely be borne by the small company D&O and E&O markets. As with most forms of deregulation there is an associated risk of fraud and abuse which could lead to claims by aggrieved investors that they were misled either by the company's raising capital via crowdfunding, or, perhaps the greater risk to small and midmarket D&O and E&O carriers, claims against the yet-to-be-established "funding platforms," including the requirement that they provide information to investors and take certain measures to prevent or reduce fraud.

Title IV: (Reg. A+) (Not Yet Effective)

Under Title IV of the JOBS Act (which is still in the rulemaking stage), an EGC will be able to increase a public offering of securities from \$5 million to \$50 million (raised within a 12-month period) without triggering full disclosure and reporting obligations, and without being subject to state blue sky laws, which are often onerous and costly to comply with – as long as the securities are offered or sold only to qualified purchasers (as determined by the SEC) or sold on a national securities exchange. Issuers will also be able to solicit interest in an offering before filing an offering statement, and securities issued in these offerings will be freely tradable.

Title IV is built upon an already existing exemption from the registration requirements mandated by the Securities Act of 1933: Regulation A, which has long been applicable to small public offerings of securities of \$5 million or less raised in any 12-month period. Regulation A already permits an issuer to file a "mini-registration" with the SEC that allows for relatively reduced disclosures to investors, including the ability to submit "reviewed" financial statements rather than audited financial statements. Regulation A also allows the sale of securities to both accredited and unaccredited investors. The catch is that Regulation A offerings must comply with the state blue sky law requirements in each state where funds are solicited. The high cost associated with such compliance has been noted as a deterrent to small businesses that would otherwise benefit from utilization of Regulation A. By lifting the requirement that issuers comply with blue sky laws and lifting the maximum amount that can be raised to \$50 million, Title IV – often referred to as "Regulation A+" – will likely be an appealing option for EGCs.

While disclosure requirements will be scaled-down for issuers under Title IV, issuers will still be required to file annual audited financial statements with the SEC and make certain periodic non-financial disclosures available to investors. Subsequent periodic reports and annual audited financial statements will also be required to be filed, and as noted above, the securities must be offered or sold only to qualified purchasers (as determined by the SEC) or sold on a national securities exchange.

Anti-fraud measures have not been relaxed for Title IV offerings and, given the high (\$50 million) ceiling for these offerings, Title IV has the potential to give rise to high-exposure claims under both D&O and E&O policies. Potential claims arising out of Title IV include Rule 10b-5 suits and SEC investigations against issuers and auditors arising from statements in subsequent periodic reports and audited financial statements, and potential SEC actions and follow-on shareholder suits arising out of alleged sales to non-qualified purchasers. Some insurers will likely consider excluding claims arising under Title IV, or, alternatively, offering policies with a sublimit or a higher retention applicable to such claims.

Titles V and VI (Effective April 5, 2012) – Increased Shareholder Thresholds for Mandatory Registration/ Reporting

Titles V and VI of the JOBS Act (which are fully in effect) amend Section 12(g) and Section 15(d) of the Securities Exchange Act of 1934. Prior to the enactment of the JOBS Act, Section 12(g) of the Exchange Act required companies with more than \$10 million in assets and a class of equity securities held by 500 or more holders to register that class of securities with the SEC, thereby becoming subject to various reporting and other requirements. Section 15(d), in turn, required a company that registered securities for public sale under the Securities Act but did not meet the registration requirements of Section 12(b) or 12(g) of the Exchange Act, to file certain periodic reports for at least the first fiscal year in which its Securities Act registration statement was effective.

Now, under Title V, a company (other than a bank or a bank holding company) can increase the number of its shareholders of record from 500 to 2,000 before it must register its securities or file periodic reports, as long as fewer than 500 of its investors are non-accredited). In calculating the number of holders of record, issuers may exclude certain holders who received the securities pursuant to an employee compensation plan, as well as shareholders that hold shares under a "street name," and "crowd-funded" shareholders.

Title VI applies to banks and bank holding companies. Similarly to Title V, it permits a bank or a bank holding company to increase the number of its shareholders of record from 500 to 2,000 before it must register its securities or file periodic reports. Unlike Title V, however, Title VI does not impose a requirement for a maximum number of non-accredited investors. Title VI also permits a bank or a bank holding company to de-register any registered securities (thereby freeing itself of reporting requirements with respect to those securities) if the number of record holders for the securities falls below 1,200 persons. (The threshold is 300 for non-banks and bank holding companies.)

Anti-fraud laws, including Rule 10b-5, continue to apply to offerings and sales by these companies. Therefore, potential claims arising out of Titles V and VI could include regulatory actions and follow-on shareholder suits alleging fraud or errors in calculating the number of shareholders of record and accredited investors for purposes of the Act, and related securities class actions. While Titles V and VI were created to lower costs to EGCs, they may therefore increase EGCs' record-keeping expenses related to counting shareholders of record, and could give rise to potential suits against these issuers.

Conclusion

The JOBS Act is still a work in progress. Titles III and IV have not yet been enacted, and the SEC has received thousands of comments from individuals and entities about them in the rulemaking process. While it will be some time before we know the full impact of this legislation on the U.S. economy, two things are certain: First, given its roll-backs of certain disclosure and registration requirements, even for large offerings, the Act could give rise to many different types of large securities and investment adviser claims, potentially exposing both D&O and E&O insurers and giving rise to new JOBS Act-related policy endorsements, exclusions, retentions, separate coverages, and/or sublimits.

Second, if it is implemented, developed, and enforced in a way that considers its impact on real people, the Act certainly has the potential to fulfill its ultimate goals of increasing jobs and fostering innovation and prosperity in the U.S.