

2014 Update On The JOBS Act - Beware: Some Assembly Required

Written By **E. Knox Proctor V** (ekp@wardandsmith.com)

September 19, 2014



The Jumpstart Our Business Startups Act ("JOBS Act" or "Act") was a bipartisan effort in Congress to unleash the power of 21st Century communications methods and systems into the capital-raising process; to make it less burdensome for smaller companies to become publicly-held and remain publicly-held; allow smaller businesses to remain private even if they have a relatively large number of shareholders; and, create jobs by making it easier for start-up companies to deal with securities laws when raising capital. It was signed by the President on April 5,

2012. Most of the Act's provisions require the Securities and Exchange Commission ("SEC") to enact rules to implement those provisions before they become effective.

Did you ever buy a Christmas toy for your children that had on the box the dreaded words: "Some Assembly Required"? If so, then you will understand the current status of the JOBS Act several years after passage:

- Some parts appear to work as intended.
- Some parts seem to be missing.
- There are some extra parts that don't appear to belong anywhere.
- The assembly instructions were not written by native English speakers.

The three-year delay in implementing major parts of the JOBS Act has been caused in part by both poor design and an assembler, the SEC, that would really rather be doing something else.

SEC Obstruction of the JOBS Act's Effectiveness

The SEC has missed every one of the statutory deadlines for proposing rules. So far only one proposed rule has become effective. That's an impressive success rate for a delay strategy. But the SEC is fighting a losing battle against the Act. The Internet and social media won't disappear and their influence grows stronger as they permeate our lives while the SEC's delay and outdated interpretation of the securities laws seem more foolish as every day passes. Recently, for example, the SEC had to surrender to Twitter® by permitting issuers that use Twitter® or any other technology that limits the space that can be used (for example, Twitter's 140-character limit) to link to other documents that contain required SEC legends that are too long to fit the technology's space limitations.

The primary issue is that some of the SEC's proposed rules (or statements about what the SEC thinks the Act means) threaten to so substantially limit the practical usefulness and cost-efficiency of some JOBS Act offerings that the very purposes of the Act are threatened.

Statutory Imperfections

However, not all of the Act's problems can be blamed on a reluctant SEC. Congress is also at fault. The Act contains a number of ambiguities and provisions that make its procedures and requirements very cost inefficient for businesses trying to raise capital.

Part of the problem is just poor draftsmanship. But the other catalyst is the fact that Congress was split between two goals for the Act:

- Increasing the efficiency of capital-raising by small- to mid-sized businesses; and,
- Defending against allegations by critics that investor protection was being abandoned.

Investor protection forces in Congress contributed substantially to the confusing language and unreasonable conditions the SEC is using to create restrictive rules.

Anti-Fraud Rules Remain Unchanged

Before reviewing the current status of the JOBS Act and the existing and proposed implementation rules, it should be noted that congressional committees are working on changes to the Act. Some of these changes are required in order to clarify ambiguous language. Other changes are necessary to offset unfortunate SEC interpretations of the Act and SEC rules that threaten to negate many of the Act's intended benefits.

Initial Successes of the JOBS Act

Notwithstanding the problems identified above, it should be noted that the JOBS Act has already helped many issuers raise capital. Rule 506(c) offerings using general solicitations are growing in number and size. Likewise, many issuers have benefitted from the new confidentiality and other rules governing an Initial Public Offering ("IPO") and Securities Exchange Act of 1934 ("Exchange Act") reporting by emerging growth companies. These are substantial and beneficial changes that should not be overlooked as they make capital-raising regulations reasonable and cost efficient in light of 21st Century technology and communications tools and practices.

Although this article is intended to give an updated overview of JOBS Act developments, it is important to note that most of the provisions in the Act are not yet effective. A further update will be published when all of the final regulations are in place.

Overview of the JOBS Act

The JOBS Act is a wide-ranging piece of legislation that amends multiple sections of both the Securities Act of 1933 ("Securities Act") and the Exchange Act. Some sections of the Act became operative when the statute was enacted. Other sections instruct the SEC to write rules implementing them.

The following table gives a brief description of the primary provisions of the JOBS Act as well as their current regulatory status and some of the important issues related to using each provision.

| JOBS ACT SECTION | DESCRIPTION | CURRENT STATUS AND ISSUES |
|--------------------------------|--|---|
| Title I Sections 101 to 108 | "IPO On-Ramp" – Grants relief for "Emerging Growth Companies" in IPOs and in their subsequent reporting and compliance | Currently effective and has been utilized by most companies issuing IPOs since it became effective. |

| | | |
|--|--|---|
| | obligations. | |
| Title II Section 201(a) | Rule 506 Private Offerings General Solicitation and Advertising – Allows general solicitation and advertising of Rule 506(c) private offerings that are exempt from registration, if an issuer takes reasonable steps to verify that all investors are "accredited investors." | <p>Final SEC rules were approved July 10, 2013 and became effective September 23, 2013. The SEC proposed additional rules on July 10, 2013.</p> <p>The initial SEC rules represented a fair attempt to implement Congressional intent to promote capital-raising.</p> <p>Investor verification rules are being implemented without undue burdens both the number and size of Rule 506 offerings are growing month by month more people recognize the benefits.</p> <p>Proposed SEC rules regarding change SEC Form D and requiring the filing of communications with the SEC on the they occur impose impractical burden that will make it difficult and more expensive for young businesses to comply with the rules, thereby exposing them to the risk of liability.</p> |
| Title II Section 201(c) | Broker-Dealer Registration Exemption – Affords exemptions from the requirement to register as a broker under Section 15(a)(1) of the Exchange Act to technology platform operators and people who co-invest in issuers. | <p>Became effective immediately.</p> <p>The SEC has not proposed any rules, has issued statements in FAQs that indicate its position that technology platforms used to sell securities in Rule 506 offerings can be operated only by registered broker-dealers and venture capital funds.</p> <p>The primary legal issue is whether technology platform operators should be treated like (i) media outlets or telecommunications system operator who provide technology-enabled services permitting others to offer and sell securities, or (ii) a broker who actually effects offers and conducts sales of securities. That is, should technology platform operators be treated more like Comcast®, Verizon®, or The Wall Street Journal® or more like Merrill Lynch®?</p> |
| | Bad Actor Rules – Not officially part of the JOBS Act, but mandated by the Dodd-Frank Act and issued at the same time as the Rule 506 | <p>SEC rules were approved July 10, 2013 and became effective September 23, 2013.</p> <p>Add paperwork and investigation to t</p> |

| | | |
|---|---|--|
| | <p>advertising and solicitation regulations.</p> <p>Prohibit companies from using Rule 506 to raise capital if they have investors, officers, and other associated persons who have committed a list of bad acts.</p> | <p>Rule 506 offering process as well as the risk of liability for failing to identify bad actors, but on the whole are justifiable to protect investors from bad actors.</p> |
| <p>Title III</p> <p>Sections 301 to 305</p> | <p>"Crowdfunding" - Allows companies to obtain limited investments (up to \$1 million per issuer per year and up to \$10,000 per investor per year) from the general public (both accredited and non-accredited investors) without registration, but through strictly regulated crowdfunding platforms.</p> <p>Rules regulate both the issuers raising capital and technology platform operators.</p> | <p>The SEC proposed rules on October 2, 2013 that are not yet effective.</p> <p>Primary issues with the proposed rule include:</p> <ul style="list-style-type: none"> • Requiring the use of reviewed and audited financial statements increases offering expenses to a high percentage of the \$1 million annual limit per issuer. • Requiring annual filings with the SEC creates ongoing expense and loss of confidentiality for issuers. • Limits on the fees that technology platform operators can charge and limits on ownership of issuers by technology platform operators potentially limit technology platform operator profits. • Limiting off-platform communications by issuers impedes sales efforts. • Prohibiting technology platform operators from making recommendations limits usefulness to investors who seek to find the best investment opportunities. |
| <p>Title IV</p> <p>Sections 401 to 402</p> | <p>"Small Offerings - Regulation A+" - Provides exemptions for certain smaller offerings of securities.</p> <p>Primary change is to create different rules for (i) offerings up to \$5 million and (ii) offerings up to \$50 million (including \$15 million of shareholder e-sales). Also exempts the offerings from certain state securities laws.</p> <p>Regulation A offerings were limited to \$5 million and most issuers utilized the more flexible Rule 506</p> | <p>The SEC proposed rules on December 18, 2013 that are not yet effective.</p> <p>The primary issue will be whether Regulation A+ can compete with the flexibility of Rule 506(c) offerings or the traditional IPO process.</p> <p>May be most useful for small public companies that have some trading volume because the securities are not restricted.</p> |

| | | |
|--|---|------------------------------------|
| | offerings, which has always provided exemption from certain state securities laws. Advantages of Regulation A+ compared to Rule 506 offerings include the ability to sell to persons who are not accredited investors and to issue securities that are not "restricted securities," which make resale easier if there is a trading market. | |
| Title V Sections 501 to 504 | Exchange Act Triggers – Increase the maximum number of record shareholders that, when exceeded, trigger registration and ongoing reporting requirements under the Exchange Act. | The rules are working as intended. |

Summary

The JOBS Act has already resulted in substantial benefits for many capital-hungry small- to mid-sized companies. It also is already changing in many ways the methods for raising capital. However, the full benefits envisioned for the Act will not be realized until some unfortunate language in the Act is removed and the SEC is convinced to write reasonable rules. Examples of both the benefits and the limitations are:

- **Rule 506(c) Private Offerings General Solicitation and Advertising Provisions.** Allowing general solicitation and advertising in Rule 506(c) private offerings may hold the most promise for companies, but the SEC's proposed rules imposing waiting periods and requiring same-day filing with the SEC of all public investor communications will make it difficult for issuers to use cost-efficient social media, because social media usually requires a user to have multiple interactions to engage an online community. For additional information about Rule 506(c), follow this link: **Rule 506 (c) Private Offerings General Solicitation and Advertising Provisions.**
- **The "Bad Actor" Final Rules.** The "Bad Actor" rules prohibit an issuer from using Rule 506 exemptions from registration if any of the issuer's affiliated persons (including officers, directors, promoters, and persons who beneficially own a 20% interest) or any persons affiliated with the broker or finder participating in the offering have committed any of the securities or other financial violations listed in Rule 506. This adds another layer of due diligence requirements for issuers and their investment bankers and attorneys. The "Bad Actor" rules were mandated by the Dodd-Frank Act, but the SEC issued the rules when it issued Rule 506(c) under the JOBS Act. For additional information about the "Bad Actor" rules, follow this link: **The SEC Rule 506 "Bad Actor" Final Rules .**
- **Deal Makers in the Rule 506 Market – Section 201(c) of the JOBS Act .** Section 201(c) of the Act grants an exemption from registration as a broker-dealer for operators of technology platforms providing certain due diligence services. The SEC has indicated on its website and through speeches by SEC personnel that this exemption is available only to professional venture capital investors. The SEC's position limits competition and deprives issuers of capital-raising opportunities – especially for issuers that may appeal to niche investor groups to whom non-traditional platform operators would market. For additional information about Section 201(c), follow this link: **Deal Makers in the Rule 506 Market – Section 201(c) of the JOBS Act .**

- **Proposed Crowdfunding Rules.** "Crowdfunding" has received much hype, but the monetary limitations and offering conditions imposed may limit its practicality for most issuers. For additional information about the proposed crowdfunding rules, follow this link: **SEC Proposed Crowdfunding Rules.**
- **Small Offerings Getting Bigger - Regulation A+.** The Regulation A+ Small Offerings Exemption may provide an alternative to registered offerings for some issuers wanting to reach retail investors. It remains to be seen whether it will be utilized given its limitations and the substantial burdens it imposes compared to a Rule 506 offering. For additional information about Regulation A+, follow this link: **Small Securities Offerings Getting Bigger - Regulation A+.**
- **Exchange Act Registration and Reporting Triggers.** The changes to the Exchange Act triggers will greatly reduce compliance burdens on companies whose future capital raises create more than 500 shareholders of record, and may be helpful to some companies that are already registered. For additional information about the revised Exchange Act triggers, follow this link: **Exchange Act Registration and Reporting Triggers.**
- **"IPO On-Ramp" Provisions.** The IPO On-Ramp has somewhat eased the burden of raising capital. For additional information about the "IPO On-Ramp" provisions, follow this link: **"IPO On-Ramp" Provision.**

--

© 2024 Ward and Smith, P.A. For further information regarding the issues described above, please contact E. Knox Proctor V.

This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.