Deal Makers in the Rule 506 Market - Section 201(c) of the JOBS Act

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There can't be a vibrant securities market without deal makers. Someone has to bring buyers and sellers together so they can do deals. Traditionally, that was Wall Street's job. But Wall Street has merged with London, Frankfurt, Hong Kong, and Shanghai to form a global market. When the market "went global," it left a vacuum in a big part of the market for small- and mid-sized companies.

A basic thrust of the Jumpstart Our Business Startups Act ("JOBS Act") is that general solicitation and advertising (and, more specifically, technology platforms and social media) are supposed to help fill this vacuum.

But technology does not work by itself.

- Someone has to build it.
- Someone has to maintain it.
- Someone has to operate it.

So, the first issue in building a vibrant Rule 506 market is: Who is allowed to operate the technology?

Traditionally, registered broker-dealers were the market makers. But both the 2008-2009 crash and many changes in technology have raised the questions:

- Is a registered broker-dealer really needed to operate a technology platform or to use social media to bring people together?
- Does Wall Street have the skill sets required?
- Should people who have the required skill sets be excluded because they are not registered broker-dealers?

Section 201(c) of the JOBS Act attempted to address these types of questions by providing an exemption from federal broker-dealer registration requirements for service providers that maintain technology platforms or mechanisms that "**permit**" offers, sales, purchases, negotiation, and related activities to take place with respect to securities transactions in Rule 506 offerings and Rule 144A resales of those offerings.

This reform made sense because it treated technology platform operators and social media like the securities laws have traditionally treated the old media and "technology platforms" – like telephones, TV, radio, and newspapers.

Social Media and Technology Platforms vs. Broker Activities

The word in Section 201(c) that has the most legal significance is "permits," Does the technology platform, device, or social media "**permit**" the activity to occur in the same sense that traditional media permitted securities transactions to occur. Operators of telephone systems have never been required to register as brokers even though the telephone system "permits" people to buy and sell securities. The same has been true for TV, radio, and newspapers when they carry advertisements. Even advertising agencies have not been required to register as brokers despite the fact that they provide advice and services that can help sell securities like any other product.

This raises the question: Are the modern technology platforms so different from traditional media that they should be treated differently with regard to securities offerings? The answer is not an easy one. Any regulatory framework that tries to pound the new round way of investing into the old square broker-dealer hole will be obsolete the day it is enacted. Reality TV shows like "Shark Tank" bridge the gap that used to separate investments from entertainment. On the platform side, video is replacing written materials at a rapid pace. Many issuers already use YouTube® to attract investor interest. People make investments in non-public companies for many reasons. It's not solely to obtain a return on investment. Social media often mixes financial-oriented investing with interest in social causes, hobbies, and other passions, and many modern technology platforms are likely to specialize in offerings that appeal to one or more of the expanding number of online communities.

Section 201(c) of the JOBS Act was an attempt to draw reasonable lines between this new type of investing and traditional broker-dealer activity. It provides that, to be exempt, modern technology service providers and their employees must receive no compensation in "**connection with the purchase or sale**" of securities and must not have custody of customer funds or securities. They may, however, "co-invest" in these securities and may receive compensation for performing "ancillary services" in connection with securities transactions. Ancillary services may include "the provision of due diligence services," but may not include "investment advice or recommendations." Ancillary services also may include "the provision of standardized documents," subject to certain limitations.

Section 201(c) makes perfect sense and really should not be controversial if viewed simply as a way to define when a technology platform operator deserves the same treatment that has long been provided to other media operators.

Unfortunately, the Securities and Exchange Commission ("SEC") does not agree with this view of Section 201(c).

The JOBS Act required the SEC to issue rules relating to this exemption before July 4, 2012, but over two years after this deadline, it has not as yet proposed any rules. It has, however, posted FAQs and responses on its website. These FAQs indicate that the SEC believes that any compensation other than a co-investment is compensation "**in connection with the purchase and sale**" of the securities offered by using the technology platform. According to the SEC's FAQs, TV, radio, and telephone system operators can charge fees for their services "in connection with the purchase and sale" of securities, but Internet-based service providers cannot.

Because of the SEC's position that Section 201(c) does not permit modern technology platform operators to charge any fees, it has telegraphed that Section 201(c) will have practical use only for venture capital investment funds trying to bring outside investors into their portfolio companies.

The SEC's position seems completely at odds with Congress's apparent intent to draw a distinction between fees for ancillary services and fees for securities sales on Rule 506 technology platforms. The lack of rule issuance probably reflects the SEC's hostility to this provision of the JOBS Act while not committing itself to

issue rules that directly contradict the intent of the Act, a classic case of what in an individual would be classified as passive-aggressive behavior.

There cannot be a vibrant market in Rule 506 offerings until the SEC recognizes that there is a legally significant difference between:

- Service providers offering technology-enhanced services that "permit" others to buy and sell securities; and,
- People who use their technology-enhanced services to buy and sell securities.

The world has functioned reasonably well since 1933 by recognizing this distinction between people who provide telephones, radio, newspapers, and TV compared to people who use these devices and services to buy and sell securities. Likewise, advertising agencies that shape the message are not treated the same as people who buy and sell securities. The world will not fall apart by extending this same principle to Internet-based platforms, social media, and the people who provide these services.

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