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Update On The Jumpstart Our Business Startups ('JOBS') Act

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Recent rulemaking by the SEC on promising provisions of the 2012 JOBS Act is disappointing. We await further rulemaking for other provisions to be effective.

Summary

This article updates our July 2012 article on the 2012 Jumpstart our Business Startups Act, commonly referred to as the "JOBS Act," which was designed to offer better capital-raising opportunities to many tech companies and reduce their SEC compliance burdens. For fuller background of the JOBS Act, click here to see our July 2012 article on the 2012 Jumpstart Our Business Startups Act.

The Jumpstart our Business Startups Act ("JOBS Act") was a bipartisan effort to create jobs by making it easier for start-up companies to deal with securities laws when raising capital.

The major provisions of the JOBS Act:

- Create the "IPO On-Ramp," which provides regulatory relief for "Emerging Growth Companies";
- Allow advertising of private offerings in which securities are sold only to "accredited investors";
- Allow raising capital through "crowdfunding";
- Create exemptions for "Small Offerings"; and,
- Change the number of record shareholders that triggers ongoing securities reporting requirements.

Most of the JOBS Act's provisions are not effective until the U.S. Securities and Exchange Commission ("SEC") implementing rules become effective. The SEC has missed all statutory deadlines for issuing rules. The important rulemaking allowing general advertising in private offerings in which securities are sold only to accredited investors finally will become effective on September 23. The SEC appears to be intent on thwarting Congress's idea of a simple private offering.

IPO On-Ramp

The JOBS Act designates certain companies with less than $1 billion in annual gross revenue as "Emerging Growth Companies." The JOBS Act provides regulatory relief to Emerging Growth Companies in securities offerings, allowing them to "test the waters" with sophisticated investors and to receive confidential reviews of offering documents from the SEC. It also provides relief from some of the more onerous requirements of ongoing securities reporting, including some executive compensation disclosure requirements and shareholder advisory votes on executive compensation. These provisions did not require SEC rulemaking to be effective.

To date, the JOBS Act has not exactly resulted in an avalanche of initial public offerings, or "IPOs," by Emerging Growth Companies. Many of the Emerging Growth Companies which have made initial public offerings have first received a confidential nonpublic review from the SEC. Presumably, many of these

companies also have tested the waters with permissible investors.

Emerging Growth Companies may take advantage of all, some, or none of the JOBS Act's securities reporting exemptions. We can expect many, if not most, Emerging Growth Companies to use the exemptions from shareholder advisory votes on compensation and the opportunity to scale back burdensome executive compensation disclosures.

General Advertising for Private Offerings

Most private offerings are currently subject to a prohibition on general advertising. The JOBS Act requires the SEC to revise Rule 506 of "Regulation D" to eliminate this restriction so long as all purchasers of securities are "accredited investors." Although this provision of the JOBS Act probably held the most promise for enhancing capital raising, the very disappointing SEC rulemaking shows an intent to make it so cumbersome to use that it will be ineffective.

On July 10, the SEC finally gave us three rule issuances. The first two were final rules; the third issuance proposed additional rules for comment. The first final rule revises Rule 506 to allow general advertising. The issuance was a little over a year late and will not be effective until September 23. The second final rule, which also will become effective on September 23, implements a provision of the 2010 Dodd-Frank Act disqualifying "bad actors" from Rule 506 offerings. This issuance was a little over 2½ years late. The third issuance proposes extremely burdensome additional requirements for Rule 506 offerings with general advertising.

The JOBS Act lifted the ban on general advertising in private offerings if actual sales of securities were made only to "accredited investors." Those provisions also required the SEC to make rules requiring companies to take reasonable steps to determine whether purchasers were accredited investors. Congress's idea was to allow general advertising in Rule 506 offerings that basically were as simple as they are under current law.

As it was looking to improve the job market by deregulating Rule 506 offerings, the 2012 Congress may have forgotten that the 2010 Congress had required the SEC to impose the additional burdens of the "bad actor" provisions on these offerings. The SEC, of course, remembered to do so. These "bad actor" provisions, by themselves, will make all Rule 506 offerings more complicated. The proposed SEC rules then would place substantial additional burdens on Rule 506 offerings that use general advertisement. *Note*: There is a small window of time for Rule 506 offerings to be made without complying with whatever rules become final imposing additional requirements for general advertisement and solicitation offerings.

The General Advertising Final Rules: The new Rule 506 will allow a company to do a private offering with advertising if the company takes reasonable steps to verify that all purchasers are "accredited investors." The SEC rulemaking provides for a non-exclusive list of reasonable steps, including:

- Reviewing copies of an IRS form that reports income and obtaining a written representation from the purchaser that the purchaser will likely continue to earn the necessary income; and,
- Receiving written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that reasonable steps were taken to verify the purchaser's accredited investor status.

The "Bad Actor" Final Rules: The new "bad actor" rules will require issuers to take "reasonable care" to verify that no "disqualifying events" –– from a long list of securities and financial violations –– have occurred with respect to the company or any of these persons related to the company, including:

- Directors, key officers, general partners, and managing members;
- Beneficial owners of more than 20%;

- Promoters;
- Investment managers and principals of pooled investment funds; and,
- Persons paid for soliciting investors *and* their general partners, directors, officers, and managing members.

Obtaining these verifications will impose significant new burdens on Rule 506 offerings, and potential liabilities create significant new risks.

The General Advertising Proposed Rules: The proposed new rules for Rule 506 offerings that use advertising would impose many additional burdens, including:

- An advance filing of SEC Form D 15 days before engaging in general advertising;
- Additional information on SEC Form D, which one Congressman has called a "wildly expanded" Form D;
- Use of lengthy specific legends on written general solicitation materials;
- Submission to the SEC of advertising materials prior to use;
- Imposition of specific time deadlines and a disqualification period for a failure to use Form D; and,
- An updated Form D filing at the close of an offering.

The SEC does not like general advertising and solicitation in private offerings, and these rule proposals are an attempt to impose registration-like requirements on these offerings.

Crowdfunding

The JOBS Act "crowdfunding" provision will allow unregistered sales of securities in small amounts, but only after the SEC issues rules about disclosures, advertising, limitations on resale, and other conditions.

Under the JOBS Act, these rules were to have been issued by December 31, 2012. The SEC announced that it did not expect to be able to issue rules by that date, and it did not. As of this date, no rules even have been proposed.

The further requirements imposed by SEC rules may be onerous. The JOBS Act requires that the rules address "disqualification provisions," which can be expected to be substantially similar to the "bad actor" provisions discussed above. The SEC also must address complicated provisions placing limitations and requirements on intermediaries through which crowdfunded securities are sold, including providing investors with general information about investment risk as well as the particular offering.

Even if the SEC's rules on crowdfunding are surprisingly reasonable, crowdfunding will be impractical for many companies. Small companies may not wish to publicly disclose their financial statements or deal with the large number of shareholders the low investment limits may require.

Small Offerings

The JOBS Act requires the SEC to issue rules setting conditions for exemption of "small offerings" of equity, debt, and debt convertible securities, not to exceed $50 million per year (with that amount subject to later adjustments every two years). Once the rules are issued, small offerings may be sold publicly and will be exempt from state law registration requirements. "Testing the waters" with certain investors will be allowed, subject to conditions imposed by SEC rules.

Congress gave the SEC no deadline for issuing these rules. Given its history with rules which do have deadlines, it is difficult to predict when the proposed small offerings rules will be published for comment. The small offerings provisions remain ineffective without these rules.

Exchange Act Triggers

Whether companies are "public," so that they have ongoing securities reporting obligations, depends on the number of "record holders." The JOBS Act raised the number of record holders companies must have and excluded certain types of holders from the calculation.

These provisions do not depend on rulemaking to be effective, so a number of companies no longer have SEC reporting obligations. But SEC rulemaking is needed to address how some of the changes are to be implemented and establish some safe harbors for record holder determinations. The SEC has not yet proposed these rules.

Summary

The JOBS Act was intended to make it easier for capital-hungry companies, including tech companies, to avoid regulatory burdens associated with raising capital. Although the JOBS Act has provided some relief, the first SEC rulemaking is disappointing. We still await other long-delayed rulemakings.

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