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SPECIAL FEATURE

With JOBS Act, Congress mandates major SEC reform

By Stephen M. Honig

The president has signed a bill, overwhelmingly adopted by Congress, awkwardly entitled Jumpstart Our Business Start-ups Act (which, in case you have been living on Mars and have missed it, bears the unfortunate acronym JOBS Act). According to many economists, the act is about as likely to create American jobs as would be created by reading this column.

But politics being politics, counsel should realize that the act also is the most significant deregulation in the lifespan of the SEC. And it was achieved over substantial SEC objection.

I leave much of the breathless, detailed dissection of the statute to innumerable law firm alerts and bar association seminars. My task here is to put the act in context, from the standpoint of regulatory history.

Private placements

The big news is that we will be experiencing the sale of unregistered securities in the media. Gone are admonitions to restrict communication about upcoming stock offerings to written offering materials.

We once defined these non-registered offerings as "private" and thereby implicitly endorsed the ban on sales utilizing advertising and mass meetings. In the future, we should adjust our nomenclature; private placements should be renamed simply "unregistered" and their own singular taxonomy recognized.

I start with Regulation D offerings, the mechanism of choice for many emerging companies that have enough legs to attract sophisticated investors.

In a section of the JOBS Act conveniently entitled "Access to Capital for Job Creators," we learn that prohibitions against general solicitation and advertising contained in section 502(c) of Reg D will not apply to 506 offerings if all purchasers are accredited. (Similar public solicitation is permitted in Rule 144A offerings.)

The exemption from '33 Act registration contained in section 4 of the '33 Act (506 is a section 4 exemption, unlike the rest of Reg D) is amended to make clear that a 506 offering is not to be "deemed" a public offering by reason of, well, being effected publicly. Further, uncompensated intermediaries need not register as brokers.

The SEC has 90 days to adopt implementing rules.

I now turn to exempted offerings under section 3(b) of the '33 Act.

Reg A offerings under 3(b), although never "private," will be joined by another 3(b) exemption, a Reg A on testosterone for offerings up to $50 million. Many S-1 offerings may gravitate into this format. As with Reg A shares, these are freely tradable. The SEC is given nine months to promulgate regulations.

The most publicized innovation in unregistered offerings, however, is crowd-funding, a favorite of Massachusetts Sen. Scott Brown. In the belief that there is wisdom in crowds, and in the stated assurance that the JOBS Act democratizes capital formation and gives widows and orphans access to sweetheart investments that have made the rich richer, the act allows any non-reporting U.S. company to raise up to $1 million a year from any type of investor, most likely using the Internet to do so.

The urge to adopt legislation that combined social media, jobs creation and democracy must have been overwhelming to Congress.

Crowd-funding predictably brought the greatest resistance from the SEC and consumer advocates, and the Senate successfully amended the House bill (which had passed with only nine dissents) in this area.

But the regulatory matrix even after the Senate amendment remains loose: Any investor can play, provided he asserts the investment is the lesser of $2,000 or 5 percent of net worth or annual income (for earnings of at least $100,000, the caps are $10,000 or 10 percent).

Sales must be effected through a broker or registered funding "portal." All numbers limitations get marked to CPI each five years. Purchasers need hold the securities only one year (except for sales to accredited investors, which can be immediate). Congress also specifically preempted state regulation.

Crowd-funding contemplates public offering. Critics warn this will foster fraud against people least able to resist. I await the pop-up ads on the Internet.

How to protect the public? No audit is required for offerings below $500,000, and providing financial statements to this end of the retail stock market is of dubious help anyway.

Offerors and intermediaries are required to warn of risk and to "take reasonable measures to reduce the risk of fraud." It will be interesting to see if the SEC has the nerve to make significant limitations to crowd-funding in its regulatory drafting, in the face of Congress' clear intent to create a broad exemption.

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In one concession to unsophisticated investors, all crowd-funding for each individual investor is aggregated, which will limit any person's speculation. Enforcing this aggregate cap will, however, present diligence issues for offerors.

Registered offerings

The word was out that U.S. public markets were over-regulated and capital formation was being stifled. Certainly many public offerings were ending up in the U.K. and more recently in India.

Congress has tried to send a signal here: It is much easier now to register in the U.S., and post-offering disclosure requirements have been softened. The revolutionary effect of the JOBS Act on registered offerings is as sweeping as its reforms for private placements.

A new category of "emerging growth company" is established. It can be domestic or foreign and must have less than $1 billion of annual gross (marked to CPI every five years); an EGC holds that status generally for five years after an IPO (unless it hits $1 billion in gross or $700 million in market cap); an EGC registration statement requires lessened audit requirements (two years) and will be free from any SEC-enhanced audit requirements; underwriters can issue reports covering EGCs even during the offering period, another contribution to what will be a flood of communication.

Reports can include written or oral recommendations of the security they are selling. A registrant also can submit a registration statement to the SEC confidentially (becoming visible only at least three weeks before any road show), and any prior SEC comment on that submission is and must remain "confidential" under the '34 Act.

Once registered, an EGC is given substantive relief from various '34 Act provisions relating to executive compensation disclosure, proxy regulation and '34 Act reporting of financial data; and reprieves from audit review of the company report on internal financial controls (presently, new registrants are excused from this 404(b) report for only two years, not up to five), audit partner rotation and supplemental auditor disclosure.

The changes are immediate, requiring no SEC rule-making.

No details

The sweeping import of the act can be found in less-publicized sections, which cannot be dismissed as mere "details":

- Registration under the '34 Act, key to the SEC concept of "continuous disclosure" by public companies, is now required only if there are 2,000 shareholders, and even that number must exclude both crowd-funding purchasers (the very investors most likely in need of the disclosures) and employees holding shares obtained through unregistered comp plans (option or restricted stock programs).

While registration *is* required if there are 500 non-accredited investors, it is unclear how an issuer would monitor the then-status of its shareholders.

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- The SEC must study and report on the impact of "tick size," the bidding increment used in trading securities. Traditional "tick" was an eighth of a dollar and is now decimalized. The act asks for a study on whether decimalization eliminates economic incentive in supporting trading markets for emerging companies if the tick is only a penny.

- In a provision indicating the congressional belief that multi-tier regulation impedes capital formation, and not content with expressly preempting state regulation in crowd-funding, the act requests the comptroller general (not the SEC) to study "the impact of State laws … on offerings made under Regulation A … ."

As the Blue Sky process was the conceptual backstop in Reg A offerings, to balance decreased SEC scrutiny, any future preemption of the states in Reg A, which clearly is Congress' implicit suggestion in ordering the study, would drive another nail into the states' role in capital formation. Between the aggregate effects of changes to Reg D, crowd-funding, public offering relief and then Reg A preclusion, it will be hard for the states to impact capital formation except through back-end fraud enforcement.

Conclusion

Since the SEC has failed to meet its deadlines for Dodd-Frank rule-making, it is hard to see how it will meet these new drafting and study requirements absent more robust funding.

More importantly, the old, unfunny joke comes to mind: "Aside from that, how did you enjoy the play, Mrs. Lincoln?"

There is nothing in the JOBS Act to encourage the Democratic majority of SEC commissioners who opposed much of the act, nor others who favor strong securities regulation.

I hope that economists are wrong and that lots of jobs follow from this act, or that the perception of U.S. over-regulation will be sufficiently softened so as to draw back more capital formation to our shores.

Nothing short of one of these important outcomes will outweigh what many fear to be substantial unintended consequences. NEIH