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The JOBS Act and the Return of the Microcaps

Deregulating the Small Public Stock Offering. Part One of a Two-Part Article

By Aegis J. Frumento

Six years ago, I wrote in a sister publication opposing the application of the Sarbanes-Oxley Act's internal accounting control rules to small public companies, but I broke with my fellow critics on the reason why. I argued that small companies shouldn't be treated like big companies, not because they couldn't afford regulation, but because being small made them qualitatively different. Intrusive regulation made sense for large companies, I argued, because their failures could cause wide-ranging damage. Words like "systemic risk" were not yet in vogue, but that's what I meant. On the other hand, because failure and fraud in small companies would not impact the rest of the economy, they should largely be left alone, and their investors left to their traditional fraud remedies. It was, admittedly, a radical position. See Aegis J. Frumento, The Rich are Different, The Corporate Compliance & Regulatory Newsletter (May 2006), available at www.lawjournalnewsletters.com/issues/ljn_corporate/3_9/news/146512-1.html.

Now, one Great Recession later, Congress has officially recognized that small companies are indeed different by passing the Jumpstart Our Business Start-ups Act of 2012, which President Obama signed into law on April 5, 2012. Pub. Law 112-106, 126 Stat. 306 (the JOBS Act). It won't become fully implemented until next January, when — if — the SEC passes enabling rules. Even now, though, we can say with confidence that the JOBS Act will encourage small businesses and their investors to take more unregulated risks than they have been able to for a long time.

The catalyst for this change was — in case you haven't guessed — jobs. The JOBS Act rests on two recent studies. The Interim Report of the President's Council on Jobs and Competitiveness, issued in October 2011, had as one of its five recommendations, nurturing high-growth enterprises. The Report showed that firms less than five years old accounted for over 40 million jobs in the past three decades. Of those, young companies that doubled their revenues every few years accounted for an average of 88 new jobs each. However, labor statistics showed that the number of start-ups declined by 23% from 2007 to 2010, and that small IPOs declined even more.

The Report of the U.S. Treasury Department's IPO Task Force, Rebuilding the IPO On-Ramp, issued Oct. 20, 2010, showed that IPOs triggered 92% of new jobs, but declined drastically since 1996, from around 700 per year to below 200 since 2007. Small under-$50 million IPOs fell off a cliff — from 500 a year to fewer than 25. By one estimate, the IPO decline cost the nation up to 22 million new jobs, almost twice the currently unemployed. If recent-year IPOs had matched even 2007's anemic numbers, the new jobs created would have cut the current unemployment rate to 6.5%. The Task Force blamed the IPO collapse on over-regulation that made it too expensive to become a public company, and structural changes in the securities markets that made it unprofitable for broker-dealers to market small IPOs.

These studies, supported by a number of witnesses, made the somewhat obvious case that new jobs come from growing companies — not large companies (which were laying people off in droves), nor mere small companies (whose staffs tend to be stable) — but growing companies, typically new companies, and in particular companies just gone public. The avowed goal of the JOBS Act, therefore, is to create more new jobs by increasing start-ups and IPOs.

Startups and Capital

To nurture startups, the JOBS Act creates two new ways to raise capital:

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Crowdfunding and the Small Issues Exemption. Limited to $1 million and $50 million respectively, they provide minimally regulated access to public investors for seed capital and intermediate financing.

These are radical provisions. Exemptions to registration under the Securities Act of 1933 (the Securities Act) and relief from market oversight under the Exchange Act of 1934 (the Exchange Act) typically presuppose sophisticated, accredited or institutional investors who don't need regulatory protection because they can fend for themselves. Crowdfunding and the Small Issues Exemption, on the other hand, both allow capital to be raised directly from retail public investors.

Crowdfunding

Through crowdfunding, issuers can sell up to $1 million in securities to public investors, subject to two general requirements: Issuers must use a compliant broker or "funding portal," and investors cannot invest more than permitted. Investors with annual income or net worth less than $100,000 can invest annually up to 5% of their income or net worth up to $2,000; those with income or net worth above $100,000 can invest 10% up to a maximum of $100,000. JOBS Act § 301(a); Securities Act § 4(6). These are miniscule amounts, likely to comprise mere seed capital for a start-up business and not likely to put investors in much risk. Funding like this used to came from savings, home equity loans, credit cards or friends and family, but all those sources were shriveled by the economic downturn. For those entrepreneurs who can tell a convincing story, the Internet now provides access to millions of potential alternative investors. There seems to be no reason why a company cannot crowdfund $1 million raises year after year, indefinitely, and for some companies this may suffice to float them until they turn profitable and self-sufficient. Like most other shares acquired in unregistered offerings, crowdfund shares would become fully tradable under Rule 144 if held for one year. However, crowdfund investors are not counted in determining if the issuer has to publicly disclose financial information as a public company. JOBS Act § 303(a); Exchange Act § 12(g)(6). Of course, if such a company lists its shares on an exchange, or uses broker-dealer market-makers to provide market liquidity, it will need to comply with disclosure obligations tied to those activities. But crowdfunding lets a startup conduct a nano-public offering for next to nothing, even to the point of having tradable shares, and remain, to a still very large extent, private.

Crowdfunding must be done through a compliant intermediary, which can be either a broker-dealer or a "funding portal." In either case, intermediaries must comply with specific requirements, including providing risk disclosures and investor education; making sure that investors have a minimum level of investment understanding; taking appropriate anti-fraud measures; making sure funds are not delivered to the issuer prematurely; and taking reasonable measures to ensure investors do not exceed their investment limits. JOBS Act § 301(b); Securities Act § 4A(a).

For their part, issuers must file their offering documents with the Commission and the intermediary, following forms specified by SEC rules, but not near as onerous as what is required in a registration statement. The financial description of the issuer must include current year audited financial statements only if the offering is for more than $500,000. The most recent tax returns and financial statements certified by the principal officer will suffice for offerings less than $100,000, and financial statements reviewed by a certified public accountant for offerings in between. Investors must get annual reports, also filed with the Commission. Issuers cannot advertise the terms of the offering, but can only direct potential investors to the intermediary. Intermediary compensation will be governed by SEC rules. JOBS Act § 301(b); Securities Act § 4A(b).

Crowdfunding issuers are strictly liable for material misstatements and omission in connection with the offering, as under § 12 of the Securities Act. Proof of a material misstatement or omission will suffice to establish liability, but issuers may allege and prove the defense that it neither knew nor with reasonable care could have known the misstatement or omission. Investors are limited to a return of their investment with interest. JOBS Act § 301(b); Securities Act §§ 4A(c). Presumably, securities fraud actions under § 10(b) of the Exchange Act and SEC Rule 10b5-1, and state Blue Sky laws will also be available.

Funding Portals

Funding portals are a new creation. While the JOBS Act does not specifically identify them as internet websites, it's clear that's what Congress contemplated. The models are the unregulated websites that currently exist to raise funds for various charitable, artistic and commercial ventures, such as kickstarter.com and indiegogo.com. The simple idea is that just as an artist may solicit donations for an art project, an entrepreneur may solicit investments for a business project. Often, the artist will offer in return some artwork; the entrepreneur will offer equity in the business venture. But for the nature of the thing being exchanged, they are the same; and yet because a security is involved in the latter, legally it makes all the difference.

Fuding portals must register and be subject to SEC rulemaking, examination and enforcement. They need not register as broker-dealers, but they must join a national association recognized by the SEC under the Exchange Act. JOBS Act § 304(a); Exchange Act § 3(h). At the moment there is only one — the Financial Industry Regu-

latory Authority, Inc. (FINRA). Battle lines are forming over whether FINRA is an appropriate entity to regulate funding portals. Many argue, and I with them, that FINRA's culture, born of its experience with broker-dealers and securities markets, would perforce lead to excessive regulation of funding portals. It would not come as a surprise to see other organizations file applications to become national associations specifically to regulate funding portals.

The broad outlines of that regulation are already visible. The JOBS Act distinguishes funding portals by negation. They are by definition crowdfunding intermediaries that do not offer investment advice; solicit purchases, sales or offers to buy securities; compensate employees by commission on securities sold; deal in any way with investor funds; or "engage in such other activities as the Commission, by rule, determines appropriate." JOBS Act § 304(a)(2); Exchange Act § 3(a)(80). Crowdfunding portals are exempt from regulation or regulatory fees imposed by the states, except for the state of its principal place of business. JOBS Act § 305(d)(1); Exchange Act § 15(i)(2).

What Is 'Solicitation'?

The prohibition against solicitation is worth some thought. A funding portal is supposed to be neutral, merely a place where issuers can pitch their story. But this begs the question: What does solicitation mean today? Traditional marketing depends on out-bound communications; Internet marketing, on the other hand, is "in-bound." An Internet marketer does not send out brochures or place ads. Rather, he or she designs a website and optimizes it for search engines. The object is to ensure that anyone searching the web for your product finds your website listed in the first few pages of a Google search. The higher your site ranks in the Google search result list, the greater the odds of the searcher opening your site. How much old-style soliciting, then, need a funding portal do to be an effective marketer of securities? Funding portals will undoubtedly guide their issuer-clients on how best to design their web pages, including search engine optimization. That — not advertisements or cold calling — is Internet marketing, but none of it constitutes a solicitation to purchase or sell securities as currently regulated.

The Small Issues Exemption

The new Small Issues Exemption, creating a new class of exempt securities, is even more remarkable. Its $50 million limit is the same amount identified in the Jobs Counsel report and the IPO Task Force Roadmap as the upper threshold of the near-extinct microcap IPOs. Issuers using the Exemption may sell up to $50 million per year in shares. Those shares may be sold publicly and they will not be deemed "restricted securities." JOBS Act § 401(a)(2); Securities Act § 3(b)(2). Therefore, shares sold under the Small Issues Exemption could be traded immediately upon acquisition, without waiting the one-year otherwise required under the Rule 144. From the investors' perspective, this is no different than an IPO. Yet the prerequisites are modest — filing the offering statement with the SEC; filing annual audited financial statements; periodically disclosing information as SEC rules may require — but none of Securities Act's general requirements for fully registered public offerings. These securities will be subject to state Blue Sky regulation only to the extent that they are not traded on a national exchange, and even then only to the extent necessary to protect non-accredited retail investors (although the states will still be able to prosecute fraud cases); this is no different than how the states currently regulate private placements. JOBS Act §§ 305(b)(2), 401(b); Securities Act § 18(b)-(c).

Large Corporations

Although Crowdfunding and the Small Issues Exemption are intended to benefit startups and small companies, large corporations can also use them. Indeed, larger corporations, because public information is already available about them, may find it even easier to raise funds through these new vehicles than their smaller brethren. How large companies might use crowdfunding and the Small Issues Exemption is for now a speculative question, one that corporate finance lawyers and investment bankers might want to ponder. One can imagine, for example, a large company using crowdfunding to sell a minority stake in a special purpose subsidiary, especially one working on a discrete project drawing public interest. The Small Issues Exemption is even more likely to be used by larger companies. A company of any size should find it useful on occasion to be able to raise $50 million without filing full-blown registration statements. Moreover, since Exchange Act § 12(a) permits unregistered exempt securities to be traded on national securities exchanges, shares issued under the Small Issues Exemption could even become exchange-traded along with an already-public issuer's other shares without further requirements.

Even so, most companies using these new methods of raising capital will be small and fledgling. For them, the JOBS Act also provides regulatory relief so long as they fit the definition of an Emerging Growth Company. That will be the subject of Part Two of this article.

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